

GLADSTONE COMMERCIAL CORP

Form 10-Q

July 31, 2012

[Table of Contents](#)

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

**FORM 10-Q**

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2012**

**OR**

.. **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE TRANSITION PERIOD FROM TO**

**COMMISSION FILE NUMBER: 001-33097**

**GLADSTONE COMMERCIAL CORPORATION**

(Exact name of registrant as specified in its charter)

Edgar Filing: GLADSTONE COMMERCIAL CORP - Form 10-Q

**MARYLAND**  
(State or other jurisdiction of  
incorporation or organization)

**02-0681276**  
(I.R.S. Employer  
Identification No.)

**1521 WESTBRANCH DRIVE, SUITE 200**

**MCLEAN, VIRGINIA**  
(Address of principal executive offices)

**22102**  
(Zip Code)

**(703) 287-5800**

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

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

Large accelerated filer  Accelerated filer

Non-accelerated filer  (Do not check if a smaller reporting company) Smaller reporting company

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

Yes  No

The number of shares of the registrant's Common Stock, \$0.001 par value, outstanding as of July 31, 2012 was 10,945,379.

**Table of Contents**

**GLADSTONE COMMERCIAL CORPORATION**

**FORM 10-Q FOR THE QUARTER ENDED**

**JUNE 30, 2012**

**TABLE OF CONTENTS**

	PAGE
<b>PART I</b>	
<b><u>FINANCIAL INFORMATION</u></b>	
Item 1. <u>Financial Statements (Unaudited)</u>	
<u>Condensed Consolidated Balance Sheets as of June 30, 2012 and December 31, 2011</u>	3
<u>Condensed Consolidated Statements of Operations for the three and six months ended June 30, 2012 and 2011</u>	4
<u>Condensed Consolidated Statements of Cash Flows for the six months ended June 30, 2012 and 2011</u>	5
<u>Notes to Condensed Consolidated Financial Statements</u>	6
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	21
Item 3. <u>Quantitative and Qualitative Disclosures about Market Risk</u>	40
Item 4. <u>Controls and Procedures</u>	41
<b>PART II</b>	
<b><u>OTHER INFORMATION</u></b>	
Item 1. <u>Legal Proceedings</u>	42
Item 1A. <u>Risk Factors</u>	42
Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	42
Item 3. <u>Defaults Upon Senior Securities</u>	42
Item 4. <u>Mine Safety Disclosures</u>	42
Item 5. <u>Other Information</u>	42
Item 6. <u>Exhibits</u>	43
<b><u>SIGNATURES</u></b>	45

**Table of Contents****Gladstone Commercial Corporation****Condensed Consolidated Balance Sheets****(Dollars in Thousands, Except Share and Per Share Amounts)****(Unaudited)**

	June 30, 2012	December 31, 2011
<b>ASSETS</b>		
Real estate, at cost	\$ 478,410	\$ 442,521
Less: accumulated depreciation	59,433	53,784
Total real estate, net	418,977	388,737
Lease intangibles, net	45,926	37,670
Cash and cash equivalents	4,273	3,329
Restricted cash	2,889	2,473
Funds held in escrow	5,345	4,086
Deferred rent receivable, net	13,121	12,403
Deferred financing costs, net	5,789	3,473
Other assets	1,015	976
<b>TOTAL ASSETS</b>	<b>\$ 497,335</b>	<b>\$ 453,147</b>
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
<b>LIABILITIES</b>		
Mortgage notes payable	\$ 314,769	\$ 285,350
Borrowings under line of credit		18,700
Series C mandatorily redeemable preferred stock, par value \$0.001 per share; \$25 per share liquidation preference; 1,700,000 shares and no shares authorized; and 1,540,000 shares and no shares issued and outstanding at June 30, 2012 and December 31, 2011, respectively	38,500	
Deferred rent liability, net	3,440	3,851
Asset retirement obligation liability	3,812	3,289
Accounts payable and accrued expenses	4,295	1,956
Due to Adviser and Administrator <sup>(1)</sup>	779	1,188
Other liabilities	4,102	3,499
<b>Total Liabilities</b>	<b>369,697</b>	<b>317,833</b>
Commitments and contingencies <sup>(2)</sup>		
<b>STOCKHOLDERS EQUITY</b>		
Series A and B redeemable preferred stock, par value \$0.001 per share; \$25 per share liquidation preference; 2,300,000 shares authorized and 2,150,000 shares issued and outstanding at June 30, 2012 and December 31, 2011, respectively	2	2
Senior common stock, par value \$0.001 per share; 7,500,000 shares authorized and 97,435 and 60,290 shares issued and outstanding at June 30, 2012 and December 31, 2011, respectively		
Common stock, par value \$0.001 per share, 38,500,000 shares authorized and 10,945,379 shares issued and outstanding at June 30, 2012 and December 31, 2011, respectively	11	11
Additional paid in capital	212,014	211,553
Notes receivable employees	(416)	(422)
Distributions in excess of accumulated earnings	(83,973)	(75,830)

Edgar Filing: GLADSTONE COMMERCIAL CORP - Form 10-Q

Total Stockholders Equity	127,638	135,314
<b>TOTAL LIABILITIES AND STOCKHOLDERS EQUITY</b>	<b>\$ 497,335</b>	<b>\$ 453,147</b>

(1) Refer to Note 2 *Related-Party Transactions*

(2) Refer to Note 7 *Commitments and Contingencies*

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

**Table of Contents****Gladstone Commercial Corporation****Condensed Consolidated Statements of Operations****(Dollars in Thousands, Except Per Share Data)****(Unaudited)**

	For the three months ended June 30,		For the six months ended June 30,	
	2012	2011	2012	2011
<b>Operating revenues</b>				
Rental income	\$ 12,323	\$ 10,729	\$ 24,336	\$ 21,164
Tenant recovery revenue	87	87	171	170
<b>Total operating revenues</b>	<b>12,410</b>	<b>10,816</b>	<b>24,507</b>	<b>21,334</b>
<b>Operating expenses</b>				
Depreciation and amortization	3,992	3,475	7,896	6,845
Property operating expenses	353	202	686	499
Due diligence expense	528	131	688	(8)
Base management fee <sup>(1)</sup>	372	435	765	787
Incentive fee <sup>(1)</sup>	787	840	1,686	1,672
Administration fee <sup>(1)</sup>	265	260	575	516
General and administrative	404	357	787	812
<b>Total operating expenses before credits from Adviser</b>	<b>6,701</b>	<b>5,700</b>	<b>13,083</b>	<b>11,123</b>
Credit to incentive fee <sup>(1)</sup>	(674)	(445)	(1,259)	(931)
<b>Total operating expenses</b>	<b>6,027</b>	<b>5,255</b>	<b>11,824</b>	<b>10,192</b>
<b>Other income (expense)</b>				
Interest income employee loans	8	9	17	19
Other income	34	1	56	45
Interest expense	(4,885)	(4,201)	(9,458)	(8,356)
Distributions attributable to mandatorily redeemable preferred stock	(686)		(1,143)	
<b>Total other expense</b>	<b>(5,529)</b>	<b>(4,191)</b>	<b>(10,528)</b>	<b>(8,292)</b>
<b>Net income</b>	<b>854</b>	<b>1,370</b>	<b>2,155</b>	<b>2,850</b>
Distributions attributable to preferred stock	(1,024)	(1,024)	(2,047)	(2,047)
Distributions attributable to senior common stock	(22)	(15)	(41)	(31)
<b>Net (loss) income available to common stockholders</b>	<b>\$ (192)</b>	<b>\$ 331</b>	<b>\$ 67</b>	<b>\$ 772</b>
<b>Earnings per weighted average share of common stock basic &amp; diluted</b>				
(Loss) income from continuing operations (net of dividends attributable to preferred stock)	\$ (0.02)	\$ 0.04	\$ 0.01	\$ 0.08
<b>Net (loss) income available to common stockholders</b>	<b>\$ (0.02)</b>	<b>\$ 0.04</b>	<b>\$ 0.01</b>	<b>\$ 0.08</b>

Edgar Filing: GLADSTONE COMMERCIAL CORP - Form 10-Q

<b>Weighted average shares of common stock outstanding</b>				
Basic	10,945	9,782	10,945	9,522
Diluted	10,945	9,834	11,011	9,574
Earnings per weighted average share of senior common stock	\$ 0.26	\$ 0.26	\$ 0.53	\$ 0.52
Weighted average shares of senior common stock outstanding basic	84	59	76	59

<sup>(1)</sup> Refer to Note 2 *Related-Party Transactions*

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

**Table of Contents****Gladstone Commercial Corporation****Condensed Consolidated Statements of Cash Flows****(Dollars in Thousands)****(Unaudited)**

	For the six months ended June 30,	
	2012	2011
<b>Cash flows from operating activities:</b>		
Net income	\$ 2,155	\$ 2,850
<b>Adjustments to reconcile net income to net cash provided by operating activities:</b>		
Depreciation and amortization	7,896	6,845
Amortization of deferred financing costs	703	456
Amortization of deferred rent asset and liability, net	(337)	(335)
Amortization of discount and premium on assumed debt	32	62
Asset retirement obligation expense	82	77
Increase in other assets	(40)	(215)
Increase in deferred rent liability		1,255
Increase in deferred rent receivable	(739)	(715)
Increase (decrease) in accounts payable, accrued expenses, and amount due Adviser	1,931	(684)
Increase (decrease) in other liabilities	185	(36)
Leasing commissions paid	(1,101)	0
<b>Net cash provided by operating activities</b>	<b>10,767</b>	<b>9,560</b>
<b>Cash flows from investing activities:</b>		
Real estate investments	(44,903)	(15,778)
Receipts from lenders for funds held in escrow	1,127	1,143
Payments to lenders for funds held in escrow	(2,386)	(1,827)
Receipts from tenants for reserves	1,448	1,082
Payments to tenants from reserves	(1,166)	(962)
Increase in restricted cash	(416)	(69)
<b>Net cash used in investing activities</b>	<b>(46,296)</b>	<b>(16,411)</b>
<b>Cash flows from financing activities:</b>		
Proceeds from issuance of equity	522	36,603
Offering costs	(65)	(2,198)
Proceeds from issuance of mandatorily redeemable preferred stock	38,500	
Borrowings under mortgage notes payable	33,705	
Payments for deferred financing costs	(3,018)	(226)
Principal repayments on mortgage notes payable	(4,317)	(4,454)
Principal repayments on employee notes receivable	6	532
Borrowings from line of credit	13,800	27,374
Repayments on line of credit	(32,500)	(46,174)
Increase (decrease) in security deposits	133	(51)
Distributions paid for common, senior common and preferred stock	(10,293)	(9,302)
<b>Net cash provided by financing activities</b>	<b>36,473</b>	<b>2,104</b>
<b>Net increase (decrease) in cash and cash equivalents</b>	<b>944</b>	<b>(4,747)</b>



Edgar Filing: GLADSTONE COMMERCIAL CORP - Form 10-Q

Cash and cash equivalents, beginning of period	3,329	7,062
Cash and cash equivalents, end of period	\$ 4,273	\$ 2,315
NON-CASH OPERATING, INVESTING AND FINANCING INFORMATION		
Fixed rate debt assumed in connection with acquisitions	\$	\$ 11,921
Senior common dividend issued in the dividend reinvestment program	\$	4

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

**Table of Contents**

**Gladstone Commercial Corporation**

**Notes to Condensed Consolidated Financial Statements (Unaudited)**

**(Dollars in Thousands, Except Share and Per Share Data or Unless Otherwise Indicated)**

**1. Organization and Significant Accounting Policies**

Gladstone Commercial Corporation, (the *Company*), is a real estate investment trust (*REIT*), that was incorporated under the General Corporation Laws of the State of Maryland on February 14, 2003 primarily for the purpose of investing in and owning net leased industrial, commercial and retail real property and selectively making long-term industrial and commercial mortgage loans. Subject to certain restrictions and limitations, our business is managed by Gladstone Management Corporation, a Delaware corporation (the *Adviser*).

*Subsidiaries*

We conduct substantially all of our operations through a subsidiary, Gladstone Commercial Limited Partnership, a Delaware limited partnership (the *Operating Partnership*). As we currently own all of the general and limited partnership interests of the Operating Partnership through GCLP Business Trust I and II, as discussed in more detail below, the financial position and results of operations of the Operating Partnership are consolidated with those of the Company.

Gladstone Commercial Lending, LLC, a Delaware limited liability company (*Gladstone Commercial Lending*) and a subsidiary of ours, was created to conduct all operations related to real estate mortgage loans of the Company. As the Operating Partnership currently owns all of the membership interests of Gladstone Commercial Lending, the financial position and results of operations of Gladstone Commercial Lending are consolidated with those of the Company.

Gladstone Commercial Advisers, Inc., a Delaware corporation (*Commercial Advisers*) and a subsidiary of the Company, is a taxable REIT subsidiary (*TRS*), which was created to collect all non-qualifying income related to our real estate portfolio. There has been no such income earned to date. Since the Company owns 100% of the voting securities of Commercial Advisers, the financial position and results of operations of Commercial Advisers are consolidated with those of the Company.

GCLP Business Trust I and GCLP Business Trust II, each a subsidiary and business trust of the Company, were formed under the laws of the Commonwealth of Massachusetts on December 28, 2005. We transferred our 99% limited partnership interest in the Operating Partnership to GCLP Business Trust I in exchange for 100 trust shares. Gladstone Commercial Partners, LLC transferred its 1% general partnership interest in the Operating Partnership to GCLP Business Trust II in exchange for 100 trust shares.

*Interim Financial Information*

Our interim financial statements are prepared in accordance with accounting principles generally accepted in the United States of America (*GAAP*) for interim financial information and pursuant to the requirements for reporting on Form 10-Q and in accordance with Article 10 of Regulation S-X. Accordingly, certain disclosures accompanying annual financial statements prepared in accordance with GAAP are omitted. In the opinion of our management, all adjustments, consisting solely of normal recurring accruals, necessary for the fair statement of financial statements for the interim period have been included. The interim financial statements and notes thereto should be read in conjunction with the financial statements and notes thereto included in our Form 10-K for the year ended December 31, 2011, as filed with the Securities and Exchange Commission on February 28, 2012.

*Out of Period Adjustment*

During the three months ended March 31 2011, we recorded adjustments to due diligence expense, depreciation and amortization expense and to certain balance sheet accounts in connection with the property we acquired in December 2010. As a result of these errors, we understated net income by \$0.3 million for the year ended December 31, 2010, or \$0.03 per share. We concluded that these adjustments were not material to the 2010 or 2011 results of operations. As such, these adjustments were recorded during the three months ended March 31, 2011.



## **Table of Contents**

### *Use of Estimates*

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could materially differ from those estimates.

### *Reclassifications*

Certain line items on the condensed consolidated balance sheets, condensed consolidated statements of operations and condensed consolidated statements of cash flows from prior years' financial statements have been reclassified to conform to the current year presentation. These reclassifications had no effect on previously reported total assets, total liabilities, stockholders' equity or net income.

### *Real Estate and Lease Intangibles*

We record investments in real estate at cost and capitalize improvements and replacements when they extend the useful life or improve the efficiency of the asset. We expense costs of repairs and maintenance as such costs are incurred. We compute depreciation using the straight-line method over the estimated useful life or 39 years for buildings and improvements, 5 to 7 years for equipment and fixtures, and the shorter of the useful life or the remaining lease term for tenant improvements and leasehold interests.

We account for our acquisitions of real estate in accordance with Accounting Standards Codification (ASC) 805, Business Combinations, which requires that the purchase price of real estate be recorded at fair value and allocated to the acquired tangible assets and liabilities, consisting of land, building, tenant improvements, long-term debt and identified intangible assets and liabilities, consisting of the value of above-market and below-market leases, the value of in-place leases, the value of lease origination costs, the value of tenant relationships and the value of capital lease obligations, based in each case on their fair values. ASC 805 also requires that all expenses related to the acquisition be expensed as incurred, rather than capitalized into the cost of the acquisition.

Management's estimates of fair value are made using methods similar to those used by independent appraisers (e.g. discounted cash flow analysis). Factors considered by management in its analysis include an estimate of carrying costs during hypothetical expected lease-up periods considering current market conditions and costs to execute similar leases. We also consider information obtained about each property as a result of our pre-acquisition due diligence, marketing and leasing activities in estimating the fair value of the tangible and intangible assets and liabilities acquired. In estimating carrying costs, management also includes real estate taxes, insurance and other operating expenses and estimates of lost rentals at market rates during the hypothetical expected lease-up periods, which primarily range from nine to eighteen months, depending on specific local market conditions. Management also estimates costs to execute similar leases, including leasing commissions, legal and other related expenses to the extent that such costs are not already incurred in connection with a new lease origination as part of the transaction.

We allocate purchase price to the fair value of the tangible assets of an acquired property by valuing the property as if it were vacant. The "as-if-vacant" value is allocated to land, building and tenant improvements based on management's determination of the relative fair values of these assets. Real estate depreciation expense on these tangible assets was \$2.9 million and \$5.6 million for the three and six months ended June 30, 2012, respectively, and \$2.5 million and \$4.9 million for the three and six months ended June 30, 2011, respectively.

Above-market and below-market in-place lease values for owned properties are recorded based on the present value (using an interest rate which reflects the risks associated with the leases acquired) of the difference between (i) the contractual amounts to be paid pursuant to the in-place leases and (ii)

## **Table of Contents**

management's estimate of fair market lease rates for the corresponding in-place leases, measured over a period equal to the remaining non-cancelable term of the lease. When determining the non-cancelable term of the lease, we evaluate if fixed-rate renewal options, if any, should be included. The capitalized above-market lease values, included in the accompanying balance sheet as part of deferred rent receivable, are amortized as a reduction of rental income over the remaining non-cancelable terms of the respective leases. Total amortization related to above-market lease values was \$0.1 million and \$0.2 million for both the three and six months ended June 30, 2012 and 2011, respectively. The capitalized below-market lease values, included in the accompanying condensed consolidated balance sheets as part of deferred rent liability, are amortized as an increase to rental income over the remaining non-cancelable terms of the respective leases. Total amortization related to below-market lease values was \$0.2 million and \$0.5 million for the three and six months ended June 30, 2012, respectively, and \$0.3 million and \$0.5 million for the three and six months ended June 30, 2011, respectively.

The total amount of the remaining intangible assets acquired, which consists of in-place lease values, unamortized lease origination costs, and customer relationship intangible values, are allocated based on management's evaluation of the specific characteristics of each tenant's lease and our overall relationship with that respective tenant. Characteristics to be considered by management in determining these values include the nature and extent of our existing business relationships with the tenant, growth prospects for developing new business with the tenant, the tenant's credit quality and our expectations of lease renewals (including those existing under the terms of the lease agreement), among other factors.

The value of in-place leases and unamortized lease origination costs are amortized to expense over the remaining term of the respective leases, which generally range from 10 to 15 years. The value of customer relationship intangibles, which is the benefit to us resulting from the likelihood of an existing tenant renewing its lease, are amortized to expense over the remaining term and any anticipated renewal periods in the respective leases, but in no event does the amortization period for intangible assets exceed the remaining depreciable life of the building. Should a tenant terminate its lease, the unamortized portion of the above-market and below-market lease values, in-place lease values, unamortized lease origination costs and customer relationship intangibles will be immediately charged to the related income or expense. Total amortization expense related to these intangible assets was \$1.1 million and \$2.2 million for the three and six months ended June 30, 2012, respectively, and \$1.0 million and \$1.9 million for the three and six months ended June 30, 2011, respectively.

### *Impairment*

We account for the impairment of real estate, including intangible assets, in accordance with ASC 360-10-35, Property, Plant, and Equipment, which requires us to periodically review the carrying value of each property to determine if circumstances indicate impairment of the carrying value of the investment exists or that depreciation periods should be modified. If circumstances support the possibility of impairment, we prepare a projection of the undiscounted future cash flows, without interest charges, of the specific property and determine if the investment in such property is recoverable.

In light of current economic conditions, we evaluate our entire property portfolio each quarter for any impairment indicators and perform an impairment analysis on those select properties that have an indication of impairment. In performing the analysis, we consider such factors as the tenants' payment history and financial condition, the likelihood of lease renewal, business conditions in the industry in which the tenants operate and whether there are indications that the fair value of the real estate has decreased. We concluded that none of our properties were impaired as of June 30, 2012, and will continue to monitor our portfolio for any indicators that may change this conclusion. There have been no impairments recognized on real estate assets since inception.

---

**Table of Contents***Deferred Financing Costs*

Deferred financing costs consist of costs incurred to obtain financing, including legal fees, origination fees and administrative fees. The costs are deferred and amortized using the straight-line method, which approximates the effective interest method, over the term of the secured financing. We made payments of \$0.6 million and \$3.0 million for deferred financing costs during the three and six months ended June 30, 2012, respectively, and \$0.2 million for both the three and six months ended June 30, 2011, respectively. The payments incurred during the six months ended June 30, 2012 were primarily related to the issuance of our 7.125% Series C Cumulative Term Preferred Stock, (the Term Preferred Stock), discussed in further detail in Note 6 Mandatorily Redeemable Preferred Stock. Total amortization expense related to deferred financing costs is included in interest expense and was \$0.4 million and \$0.7 million for the three and six months ended June 30, 2012, respectively, and \$0.2 million and \$0.5 million for the three and six months ended June 30, 2011, respectively.

*Revenue Recognition*

Rental revenue includes rents that each tenant pays in accordance with the terms of its respective lease reported evenly over the non-cancelable term of the lease. Most of our leases contain rental increases at specified intervals. We recognize such revenues on a straight-line basis. Deferred rent receivable in the accompanying condensed consolidated balance sheet includes the cumulative difference between rental revenue, as recorded on a straight-line basis, and rents received from the tenants in accordance with the lease terms, along with the capitalized above-market in-place lease values of certain acquired properties. Accordingly, we determine, in our judgment, to what extent the deferred rent receivable applicable to each specific tenant is collectable. We review deferred rent receivable, as it relates to straight line rents, on a quarterly basis and take into consideration the tenant's payment history, the financial condition of the tenant, business conditions in the industry in which the tenant operates and economic conditions in the geographic area in which the property is located. In the event that the collectability of deferred rent with respect to any given tenant is in doubt, we record an allowance for uncollectable accounts or record a direct write-off of the specific rent receivable. No such reserves or direct write-offs have been recorded to date.

Tenant recovery revenue includes payments from tenants as reimbursements for franchise taxes, management fees, insurance, and ground lease payments. We recognize tenant recovery revenue in the same periods that we incur the related expenses.

*Asset Retirement Obligations*

ASC 410, Asset Retirement and Environmental Obligation, requires an entity to recognize a liability for a conditional asset retirement obligation when incurred if the liability can be reasonably estimated. ASC 410-20-20 clarifies that the term Conditional Asset Retirement Obligation refers to a legal obligation (pursuant to existing laws or by contract) to perform an asset retirement activity in which the timing and/or method of settlement are conditional on a future event that may or may not be within the control of the entity. ASC 410-20-25-6 clarifies when an entity would have sufficient information to reasonably estimate the fair value of an asset retirement obligation. The Company has accrued a liability and corresponding increase to the cost of the related properties for disposal related to all properties constructed prior to 1985 that have, or may have, asbestos present in the building. The liabilities are accreted over the life of the leases for the respective properties. There was \$442 in liabilities accrued in connection with acquisitions during the six months ended June 30, 2012. There were no liabilities accrued during the six months ended June 30, 2011, as the properties acquired during this period were constructed after 1985. The Company also recorded expenses of \$41 and \$82 during the three and six months ended June 30, 2012 respectively, and \$39 and \$77 during the three and six months ended June 30, 2011, respectively, related to the accretion of the obligation. Costs of future expenditures for obligations are discounted to their present value. The aggregate undiscounted obligation on all properties is \$9.5 million and the discount rates used in the calculations ranges from 2.5% to 7.6%. The Company does not expect to make any payments in conjunction with these obligations in each of the next five years.

*Comprehensive Income*

For the three and six months ended June 30, 2012 and 2011, comprehensive income equaled net income; therefore, a separate statement of comprehensive income is not included in the accompanying condensed consolidated financial statements.

*Recent Accounting Pronouncements*

In May 2011, the Financial Accounting Standards Board, or FASB, issued Accounting Standards Update, or ASU, 2011-04 which results in a consistent definition of fair value and common requirements for measurement of and disclosure about fair value between GAAP and International Financial Reporting Standards, or IFRS. ASU 2011-04 is effective for interim and annual periods beginning after December 15, 2011, and as such, we have increased our disclosures related to Level 3 fair value measurement of our mortgage notes payable, in addition to other required disclosures. There were no related impacts on our financial position or results of operations.

**2. Related-Party Transactions**

We are externally managed pursuant to contractual arrangements with our Adviser and Gladstone Administration, LLC (the Administrator ), which collectively employ all of our personnel and pays their salaries, benefits, and general expenses directly. We have an advisory agreement with our Adviser (the

---

## **Table of Contents**

Advisory Agreement ) and an administration agreement with our Administrator (the Administration Agreement ). The management services and administrative fees under the Advisory and Administration Agreements are described below. As of June 30, 2012 and December 31, 2011, respectively, \$0.8 million and \$1.2 million were due to the Adviser and Administrator.

### *Advisory Agreement*

The Advisory Agreement provides for an annual base management fee equal to 2% of our total stockholders' equity, less the recorded value of any preferred stock ( common stockholders' equity ), and an incentive fee based on funds from operations ( FFO ). For both the three and six months ended June 30, 2012 and 2011, we recorded a base management fee of \$0.4 million and \$0.8 million, respectively.

For purposes of calculating the incentive fee, FFO includes any realized capital gains and capital losses, less any distributions paid on preferred stock and senior common stock, but FFO does not include any unrealized capital gains or losses. The incentive fee rewards the Adviser if our quarterly FFO, before giving effect to any incentive fee ( pre-incentive fee FFO ), exceeds 1.75%, or 7% annualized (the hurdle rate ), of total common stockholders' equity. The Adviser receives 100% of the amount of the pre-incentive fee FFO that exceeds the hurdle rate, but is less than 2.1875% of our common stockholders' equity. The Adviser also receives an incentive fee of 20% of the amount of our pre-incentive fee FFO that exceeds 2.1875% of common stockholders' equity.

For the three and six months ended June 30, 2012, we recorded an incentive fee of \$0.8 million and \$1.7 million, respectively, offset by a credit related to an unconditional, voluntary and irrevocable waiver issued by the Adviser of \$0.7 million and \$1.3 million, respectively, resulting in a net incentive fee for the three and six months ended June 30, 2012, of \$0.1 million and \$0.4 million, respectively. For the three and six months ended June 30, 2011, we recorded an incentive fee of \$0.8 million and \$1.6 million, respectively, offset by a credit related to an unconditional and irrevocable voluntary waiver issued by the Adviser of \$0.4 million and \$0.9 million, respectively, resulting in a net incentive fee for the three and six months ended June 30, 2011, of \$0.4 million and \$0.7 million, respectively. Our Board of Directors accepted the Adviser's offer to waive, on a quarterly basis, a portion of the incentive fee for the three and six months ended June 30, 2012 and 2011, in order to support the current level of distributions to our stockholders. This waiver may not be recouped by the Adviser in the future.

### *Administration Agreement*

Pursuant to the Administration Agreement, we pay for our allocable portion of the Administrator's overhead expenses in performing its obligations to us, including, but not limited to, rent and the salaries and benefits of its personnel, including our chief financial officer and treasurer, chief compliance officer, internal counsel, investor relations and their respective staffs. Our allocable portion of expenses is derived by multiplying the Administrator's total allocable expenses by the percentage of our total assets at the beginning of each quarter in comparison to the total assets of all companies managed by the Adviser under similar agreements. For the three and six months ended June 30, 2012, we recorded an administration fee of \$0.3 million and \$0.6 million, respectively, and for the three and six months ended June 30, 2011, we recorded an administration fee of \$0.3 million and \$0.5 million, respectively.

### *Dealer Manager Agreement*

In connection with the offering of our senior common stock (see Note 8, Stockholders' Equity, for further details) we entered into a Dealer Manager Agreement, dated March 25, 2011 (the Dealer Manager Agreement ), with Gladstone Securities, LLC (the Dealer Manager ), pursuant to which the Dealer Manager agreed to act as our exclusive dealer manager in connection with the offering. The Dealer Manager is an affiliate of ours, as its parent company is controlled by Mr. David Gladstone, our Chairman and Chief Executive Officer. Pursuant to the terms of the Dealer Manager Agreement, the Dealer Manager is entitled to receive a sales commission in the amount of 7.0% of the gross proceeds of the shares of senior common stock sold, plus a dealer manager fee in the amount of 3.0% of the gross proceeds of the shares of senior common stock sold. The Dealer Manager, in its sole and absolute discretion, may re-allocate all of



**Table of Contents**

its selling commissions attributable to a participating broker-dealer and may also re-allocate a portion of its Dealer Manager fee earned in respect of the proceeds generated by the participating broker-dealer to any participating broker-dealer as a non-accountable marketing allowance. In addition, we have agreed to indemnify the Dealer Manager against various liabilities, including certain liabilities arising under the federal securities laws. We made \$29 and \$50 of payments during the three and six months ended June 30, 2012, respectively, to the Dealer Manager pursuant to this agreement. There were no payments made during the three and six months ended June 30, 2011.

**3. Earnings per Share of Common Stock**

The following tables set forth the computation of basic and diluted earnings per share of common stock for the three and six months ended June 30, 2012 and 2011. We computed basic earnings per share for the three and six months ended June 30, 2012 and 2011 using the weighted average number of shares outstanding during the periods. Diluted earnings per share for the three and six months ended June 30, 2012 and 2011, reflects additional shares of common stock, related to our convertible senior common stock, that would have been outstanding if dilutive potential shares of common stock had been issued, as well as an adjustment to net income available to common stockholders as applicable to common stockholders that would result from their assumed issuance.

	For the three months ended June 30,		For the six months ended June 30,	
	2012	2011	2012	2011
<b>Calculation of basic earnings per share of common stock:</b>				
Net (loss) income available to common stockholders	\$ (192)	\$ 331	\$ 67	\$ 772
Denominator for basic weighted average shares of common stock (in thousands)	10,945	9,782	10,945	9,522
Basic (loss) earnings per share of common stock	\$ (0.02)	\$ 0.04	\$ 0.01	\$ 0.08
<b>Calculation of diluted earnings per share of common stock:</b>				
Net (loss) income available to common stockholders	\$ (192)	\$ 331	\$ 67	\$ 772
Add: Income impact of assumed conversion of senior common stock		15	41	31
Net (loss) income available to common stockholders plus assumed conversions	\$ (192)	\$ 346	\$ 108	\$ 803
Denominator for basic weighted average shares of common stock (in thousands)	10,945	9,782	10,945	9,522
Effect of convertible senior common stock (in thousands)	(1)	52	66	52
Denominator for diluted weighted average shares of common stock (in thousands)	10,945	9,834	11,011	9,574
Diluted (loss) earnings per share of common stock	\$ (0.02)	\$ 0.04	\$ 0.01	\$ 0.08

(1) The convertible senior common stock was excluded from the calculation of diluted earnings per share for the three months ended June 30, 2012 because it was anti-dilutive.

**4. Real Estate and Intangible Assets***Real Estate*

The following table sets forth the components of our investments in real estate as of June 30, 2012 and December 31, 2011:

Edgar Filing: GLADSTONE COMMERCIAL CORP - Form 10-Q

	June 30, 2012	December 31, 2011
Real estate:		
Land	\$ 65,099	\$ 60,602
Building and improvements	394,903	367,605
Tenant improvements	18,408	14,314
Accumulated depreciation	(59,433)	(53,784)
Real estate, net	\$ 418,977	\$ 388,737

**Table of Contents**

During the six months ended June 30, 2012, we acquired five properties, which are summarized below:

Location	Acquisition Date	Square Footage	Lease		Renewal Options	Total Purchase Price	Acquisition Expenses	Annualized Straight Line Rent	Debt Issued
			Term	Lease					
Ashburn, VA	1/25/2012	52,130	15 years		2 (5 years each)	\$ 10,775	\$ 102	\$ 989	N/A
Ottumwa, IA	5/30/2012	352,860	11.5 years		3 (5 years each)	7,100	47	684	5,000
New Albany, OH	6/5/2012	89,000	10.5 years		2 (5 years each)	13,333	188	1,361	N/A
Columbus, GA	6/21/2012	32,000	11.5 years		2 (5 years each)	7,320	126	656	4,750
Columbus, OH	6/28/2012	31,293	10 years		N/A	4,037	59	342	N/A

In accordance with ASC 805, we determined the fair value of acquired assets and liabilities assumed related to the properties acquired during the six months ended June 30, 2012 as follows:

Location	Land	Building	Tenant Improvements	In-place Leases	Leasing Costs	Customer Relationships	Above Market Leases	Below Market Leases	Total Purchase Price
Ottumwa, IA	212	4,743	329	940	484	499		(107)	7,100
New Albany, OH	1,658	7,511	1,235	1,122	857	903	47		13,333
Columbus, GA	1,378	3,894	626	574	473	375			7,320
Columbus, OH	542	1,856	597	391	213	325	113		4,037

Below is a summary of the total revenue and net income recognized on the properties acquired during the six months ended June 30, 2012:

Location	Acquisition Date	Rental Revenue		Net Income	
		For the three months ended		For the six months ended	
		June 30, 2012	June 30, 2012	June 30, 2012 <sup>(1)</sup>	June 30, 2012 <sup>(1)</sup>
Ashburn, VA	1/25/2012	\$ 247	\$ 431	\$ 147	\$ 262
Ottumwa, IA	5/30/2012	61	61	30	30
New Albany, OH	6/5/2012	98	98	51	51
Columbus, GA	6/21/2012	18	18	11	11
Columbus, OH	6/28/2012	3	3	3	3

<sup>(1)</sup> Does not include interest expense or acquisition related costs that are required to be expensed under ASC 805.

We acquired five properties during the six months ended June 30, 2012. The following table reflects pro-forma condensed consolidated statements of operations as if the properties were acquired as of the beginning of the earliest periods presented, which was January 1, 2011. The pro-forma earnings for the three and six months ended June 30, 2012, were adjusted to exclude \$0.5 million of acquisition-related costs incurred in 2012 related to the five properties acquired. The pro-forma earnings for the three and six months ended June 30, 2011, were adjusted to include these charges:

Operating Data:	For the three months ended June 30,		For the six months ended June 30,	
	2012	2011	2012	2011
Total operating revenue	\$ 13,071	\$ 11,905	\$ 26,073	\$ 23,512
Total operating expenses	(6,036)	(5,924)	(12,273)	(12,036)
Other expense	(5,658)	(4,413)	(10,837)	(8,735)

Edgar Filing: GLADSTONE COMMERCIAL CORP - Form 10-Q

Net income	1,377	1,568	2,963	2,741
Dividends attributable to preferred and senior common stock	(1,046)	(1,039)	(2,088)	(2,078)
Net income available to common stockholders	\$ 331	\$ 529	\$ 875	\$ 663

**Share and Per Share Data:**

Basic earnings per share of common stock	\$ 0.03	\$ 0.05	\$ 0.08	\$ 0.07
Diluted earnings per share of common stock	\$ 0.03	\$ 0.05	\$ 0.08	\$ 0.07
Weighted average shares outstanding-basic	10,945	9,782	10,945	9,522
Weighted average shares outstanding-diluted	10,945	9,834	11,011	9,574

**Table of Contents**

The weighted average amortization period for the intangible assets acquired and liabilities assumed during the six months ended June 30, 2012, were as follows:

Intangible assets & liabilities	Years
In-place leases	11.0
Leasing costs	11.0
Customer relationships	15.2
Above market leases	10.4
Below market leases	11.6
All intangible assets & liabilities	12.4

Future operating lease payments from tenants under non-cancelable leases, excluding tenant reimbursement of expenses, for the remainder of 2012 and each of the five succeeding fiscal years and thereafter is as follows:

Year	Tenant Lease Payments
Six months ending December 31, 2012	\$ 24,342
2013	45,352
2014	42,167
2015	38,279
2016	33,733
2017	31,701
Thereafter	202,159

In accordance with the lease terms, substantially all tenant expenses are required to be paid by the tenant; however, we would be required to pay property taxes on the respective properties in the event the tenants fail to pay them. The total annualized property taxes for all properties owned by us at June 30, 2012, were \$8.0 million.

On February 13, 2012, we extended the lease with the tenant occupying our property located in South Hadley, Massachusetts. The lease covering this property was extended for an additional one-year period, through January 2013. The lease was originally set to expire in February 2012. The lease provides for annual rents of approximately \$0.3 million. Furthermore, the lease grants the tenant one option to extend the lease for an additional year.

On February 14, 2012, we extended the lease with the tenant occupying our property located in San Antonio, Texas. The lease covering this property was extended for an additional eight-year period, through November 2021. The lease was originally set to expire in February 2014. The lease provides for prescribed rent escalations over the life of the lease, with annualized straight line rents of approximately \$0.8 million. Furthermore, the lease grants the tenant two options to extend the lease for a period of five years each. In connection with the extension of the lease and the modification of certain terms under the lease, we provided a tenant allowance of \$0.6 million, payable over two years, and paid \$0.3 million in leasing commissions.

On February 27, 2012, we extended the lease with the tenant occupying our property located in Roseville, Minnesota. The new lease covers approximately one-third of this property and was extended for an additional five-year period, through December 2017. The lease was originally set to expire in December 2012. The tenant in this property will pay rent on the entire building through the end of 2012, and we continue to search for new tenants to lease the remainder of the building. The new lease provides for prescribed rent escalations over the life of the lease, with annualized straight line rents of \$2.9 million for the remainder of 2012 and annualized straight line rents beginning in 2013 of \$1.2 million. Furthermore,

**Table of Contents**

the lease grants the tenant one option to extend the lease for a period of five years. In connection with the extension of the lease and the modification of certain terms under the lease, we provided a tenant allowance of \$0.4 million, payable over two years, and paid \$0.8 million in leasing commissions.

On June 27, 2012, we extended the lease with the tenant occupying our property located in Hialeah, Florida. The lease covering this property was extended for an additional five-year period, through March 2027. The lease was originally set to expire in March 2022. The lease provides for prescribed rent escalations over the life of the lease, with annualized straight line rents of approximately \$1.1 million. In connection with the extension of the lease and the modification of certain terms under the lease, we provided a tenant allowance of \$0.3 million.

*Intangible Assets*

The following table summarizes the carrying value of intangible assets and the accumulated amortization for each intangible asset class:

	June 30, 2012		December 31, 2011	
	Lease Intangibles	Accumulated Amortization	Lease Intangibles	Accumulated Amortization
In-place leases	\$ 28,449	\$ (11,087)	\$ 24,620	\$ (10,181)
Leasing costs	19,085	(6,303)	15,013	(5,663)
Customer relationships	23,327	(7,545)	20,725	(6,844)
	\$ 70,861	\$ (24,935)	\$ 60,358	\$ (22,688)

The estimated aggregate amortization expense for the remainder of 2012 and each of the five succeeding fiscal years and thereafter is as follows:

Year	Estimated Amortization Expense
Six months ending December 31, 2012	3,400
2013	5,495
2014	4,910
2015	4,508
2016	3,907
2017	3,739
Thereafter	19,967

**Table of Contents****5. Mortgage Notes Payable and Line of Credit**

Our mortgage notes payable and line of credit (the Line of Credit ) as of June 30, 2012 and December 31, 2011 are summarized below:

	Date of Issuance/ Assumption	Principal Maturity Date	Stated Interest Rate at June 30, 2012 <sup>(1)</sup>	Principal Balance Outstanding	
				June 30, 2012	December 31, 2011
<b>Fixed-Rate Mortgage Notes Payable:</b>					
	09/15/08	10/01/12 <sup>(2)</sup>	4.76%	\$ 45,233	\$ 45,233
	02/21/06	12/01/13	5.91%	8,753	8,845
	02/21/06	06/30/14	5.20%	18,140	18,345
	08/25/05	09/01/15	5.33%	20,255	20,431
	09/12/05	09/01/15	5.21%	11,921	12,019
	12/21/05	12/08/15	5.71%	18,304	18,448
	09/06/07	12/11/15	5.81%	4,181	4,219
	03/29/06	04/01/16	5.92%	16,772	16,871
	04/27/06	05/05/16	6.58%	13,247	13,409
	08/29/08	06/01/16	6.80%	5,944	6,019
	06/20/11	06/30/16	6.08%	11,424	11,505
	11/22/06	12/01/16	5.76%	13,661	13,761
	12/22/06	01/01/17	5.79%	20,886	21,037
	02/08/07	03/01/17	6.00%	13,775	13,775
	06/05/07	06/08/17	6.11%	14,240	14,240
	10/15/07	11/08/17	6.63%	15,177	15,278
	11/18/11	11/01/18	4.50%	4,304	4,352
	12/06/11	12/06/19	6.00%	8,383	8,500
	10/28/11	11/01/21	6.00%	7,130	7,190
	04/05/12	05/01/22	6.10%	18,976	
	06/21/12	07/06/22	5.05%	4,750	
	12/15/10	12/10/26	6.63%	10,196	10,402
	05/16/12	12/31/26	4.30%	2,930	
	05/30/12	05/10/27	6.50%	4,984	
	06/27/12	07/01/29	5.10%	2,015	
	03/16/05	04/01/30	6.33%		2,314
Contractual Fixed-Rate Mortgage Notes Payable:				\$ 315,581	\$ 286,193
Premiums and Discounts, net:				(812)	(843)
Total Fixed-Rate Mortgage Notes Payable:				\$ 314,769	\$ 285,350
Variable-Rate Line of Credit:	12/28/10	12/28/13	LIBOR +2.75%	\$	\$ 18,700
Total Mortgage Notes Payable and Line of Credit				\$ 314,769	\$ 304,050

<sup>(1)</sup> The weighted average interest rate on all debt outstanding at June 30, 2012 was approximately 5.72%.

<sup>(2)</sup> This note has one annual extension option remaining, which gives us the ability to extend the term of the note until October 1, 2013. As long as we are in compliance with the covenants under this loan, which we are as of June 30, 2012, we will be able to extend the maturity date of the loan.

*Mortgage Notes Payable*

## Edgar Filing: GLADSTONE COMMERCIAL CORP - Form 10-Q

As of June 30, 2012, we had 25 fixed-rate mortgage notes payable, collateralized by a total of 66 properties. The parent company has limited recourse liabilities that could result from any one or more of the following circumstances: a borrower voluntarily filing for bankruptcy, improper conveyance of a property, fraud or material misrepresentation, misapplication or misappropriation of rents, security deposits, insurance proceeds or condemnation proceeds, or physical waste or damage to the property resulting from a borrower's gross negligence or willful misconduct. We will also indemnify lenders against claims resulting from the presence of hazardous substances or activity involving hazardous substances in violation of environmental laws on a property. The weighted-average interest rate on the mortgage notes payable as of June 30, 2012 was 5.72%.



**Table of Contents**

We had \$45.2 million of balloon principal payments maturing under one of our long-term mortgages in 2011; however, the mortgage has two annual extension options through 2013, and we exercised one of these options on September 30, 2011. In connection with the exercise of the option, the interest rate reset from 4.58% to 4.76% through September 30, 2012. At the time of notification of the extension, we remitted a fee of 0.25% of the outstanding principal balance, or approximately \$0.1 million, which is recorded as a deferred financing cost in our condensed consolidated balance sheet. We also remitted a certification to the lender that our aggregate debt service coverage ratio is not less than 1.2; thus we were in compliance with all covenants under the mortgage loan. The interest rate for the one additional extension period will adjust based upon the one-year swap rate at the time of extension and a fixed spread of 4.41% and we would be required to remit another fee of 0.25% of the current outstanding principal balance.

On February 1, 2012, we repaid in full the mortgage on our property located in Canton, North Carolina in the amount of \$2.3 million. We did not incur any prepayment penalties associated with the early repayment. The original maturity date of this mortgage was April 2030.

During the six months ended June 30, 2012, we issued five long-term mortgages, which are summarized below:

Date of Issuance	Issuing Bank	Borrowings	Interest Rate	Maturity Date
4/5/2012	KeyBank National Associatoin	\$ 19,000	6.10%	5/1/2022
5/16/2012	City National Bank	2,940	4.30%	12/31/2026
5/30/2012	Modern Woodman of America	5,000	6.50%	5/10/2027
6/21/2012	Citigroup	4,750	5.05%	7/6/2022
6/27/2012	American Equity Investment Life Co.	2,000	5.10%	7/1/2029

The fair value of all fixed-rate mortgage notes payable outstanding as of June 30, 2012, was \$326.5 million, as compared to the carrying value stated above of \$314.8 million. The fair value is calculated based on a discounted cash flow analysis, using interest rates based on management's estimate of market interest rates on long-term debt with comparable terms. The fair value was calculated using Level 3 inputs of the hierarchy established by ASC 820, Fair Value Measurements and Disclosures.

Scheduled principal payments of mortgage notes payable for the remainder of 2012 and each of the five succeeding fiscal years and thereafter are as follows:

**Table of Contents**

Year	Scheduled principal payments
Six months ending December 31, 2012	\$ 47,673 <sup>(1)</sup>
2013	13,632
2014	22,304
2015	56,174
2016	59,782
2017	62,763
Thereafter	53,253
	\$ 315,581

<sup>(1)</sup> The \$45.2 million mortgage note issued in September 2008 was extended to September 30, 2012. We have an additional option to extend the maturity date until October 2013.

*Line of Credit*

In December 2010, we procured a \$50.0 million Line of Credit (with Capital One, N.A. serving as a revolving lender, a letter of credit issuer and an administrative agent and Branch Banking and Trust Company serving as an additional revolving lender and letter of credit issuer), which matures on December 28, 2013. The Line of Credit originally provided for a senior secured revolving credit facility of up to \$50.0 million with a standby letter of credit sublimit of up to \$20.0 million. On January 31, 2012, the Line of Credit was expanded to \$75.0 million and Citizens Bank of Pennsylvania was added as a revolving lender and letter of credit issuer. Currently, seven of our properties are pledged as collateral under our Line of Credit. The interest rate per annum applicable to the Line of Credit is equal to the London Interbank Offered Rate, or LIBOR, plus an applicable margin of up to 3.00%, depending upon our leverage. The leverage ratio used in determining the applicable margin for interest on the Line of Credit is recalculated quarterly. We are subject to an annual maintenance fee of 0.25% per year. Our ability to access this source of financing is subject to our continued ability to meet customary lending requirements, such as compliance with financial and operating covenants and our meeting certain lending limits. One such covenant requires us to limit distributions to our stockholders to 95% of our FFO, with acquisition-related costs required to be expensed under ASC 805 added back to FFO. In addition, the maximum amount we may draw under this agreement is based on a percentage of the value of properties pledged as collateral to the banks, which must meet agreed upon eligibility standards.

If and when long-term mortgages are arranged for these pledged properties, the banks will release the properties from the Line of Credit and reduce the availability under the Line of Credit by the advanced amount of the released property. Conversely, as we purchase new properties meeting the eligibility standards, we may pledge these new properties to obtain additional availability under the Line of Credit. The availability under the Line of Credit is reduced by letters of credit used in the ordinary course of business. We may use the advances under the Line of Credit for both general corporate purposes and the acquisition of new investments.

At June 30, 2012, there was \$0 outstanding under the Line of Credit and \$6.1 million outstanding under letters of credit at a weighted average interest rate of 2.8%. At June 30, 2012, the maximum amount we may draw was \$22.1 million. We were in compliance with all covenants under the Line of Credit as of June 30, 2012. The amount outstanding on the Line of Credit as of June 30, 2012 approximates fair value, because the debt is short-term.

**Table of Contents****6. Mandatorily Redeemable Preferred Stock**

In February 2012, we completed a public offering of 1,540,000 shares of 7.125% Series C Cumulative Term Preferred Stock, par value \$0.001 per share ( Term Preferred Stock ), at a public offering price of \$25.00 per share. Gross proceeds of the offering totaled \$38.5 million and net proceeds, after deducting underwriting discounts and offering expenses borne by us, were \$36.7 million and were used to repay a portion of outstanding borrowings under our Line of Credit, for acquisitions of real estate and for working capital. The Term Preferred Stock is traded under the ticker symbol GOODN on the NASDAQ. The Term Preferred Stock is not convertible into our common stock or any other security of ours. Generally, we may not redeem shares of the Term Preferred Stock prior to January 31, 2016, except in limited circumstances to preserve our status as a REIT. On or after January 31, 2016, we may redeem the shares at a redemption price of \$25.00 per share, plus any accumulated and unpaid dividends to and including the date of redemption. The shares of the Term Preferred Stock have a mandatory redemption date of January 31, 2017. We incurred \$1.8 million in total offering costs related to these transactions, which have been recorded as deferred financing fees on the condensed consolidated balance sheet and will be amortized over the redemption period ending January 31, 2017.

The Term Preferred Stock is recorded as liability in accordance with ASC 480, Distinguishing Liabilities from Equity, which states that mandatorily redeemable financial instruments should be classified as liabilities and therefore the related dividend payments are treated as a component of interest expense in the statement of operations.

**7. Commitments and Contingencies***Ground Leases*

We are obligated as lessee under three ground leases. Future minimum rental payments due under the terms of these leases as of June 30, 2012, are as follows:

Location	Lease End Date	For the year ended December 31,							
		For the six months ending December 31, 2012	2013	2014	2015	2016	2017	Thereafter	
Tulsa, OK	Apr-21	\$ 76	\$ 153	\$ 153	\$ 153	\$ 153	\$ 153	\$ 534	
Springfield, MA	Feb-30	43	86	86	86	86	89	1,154	
Dartmouth, MA	May-36	87	174	174	174	174	174	3,646	

**8. Stockholders Equity**

The following table summarizes the changes in our stockholders equity for the six months ended June 30, 2012:

	Preferred Stock	Senior Common Stock	Common Stock	Capital in Excess of Par Value	Notes Receivable from Employees	Distributions in Excess of Accumulated Earnings	Total Stockholders Equity
Balance at December 31, 2011	\$ 2	\$	\$ 11	\$ 211,553	\$ (422)	\$ (75,830)	\$ 135,314
Issuance of senior common stock and common stock, net				461			461
Repayment of principal on employee notes receivable					6		6
Distributions declared to common, senior common and preferred stockholders						(10,298)	(10,298)
Net income						2,155	2,155

Edgar Filing: GLADSTONE COMMERCIAL CORP - Form 10-Q

Balance at June 30, 2012	\$	2	\$	\$	11	\$	212,014	\$	(416)	\$	(83,973)	\$	127,638
--------------------------	----	---	----	----	----	----	---------	----	-------	----	----------	----	---------

**Table of Contents***Distributions*

Our Board of Directors declared the following distributions per share for the three and six months ended June 30, 2012 and 2011:

	For the three months ended June 30,		For the six months ended June 30,	
	2012	2011	2012	2011
Common Stock	\$ 0.375	\$ 0.375	\$ 0.750	\$ 0.750
Senior Common Stock	\$ 0.2625	\$ 0.2625	\$ 0.5250	\$ 0.5250
Series A Preferred Stock	\$ 0.4843749	\$ 0.4843749	\$ 0.9687498	\$ 0.9687498
Series B Preferred Stock	\$ 0.46875	\$ 0.46875	\$ 0.9375	\$ 0.9375
Series C Preferred Stock	\$ 0.4453125	N/A	\$ 0.7421875	N/A

*Ongoing Activity*

We have an open market sale agreement, or the Open Market Sale Agreement, with Jefferies & Company, Inc., or Jefferies, under which we may, from time to time, offer to sell shares of our common stock with an aggregate sales price of up to \$25.0 million on the open market through Jefferies, as agent, or to Jefferies, as principal. As of June 30, 2012, we had sold 192,365 shares with net proceeds of \$3.4 million, and have a remaining capacity to sell up to \$21.6 million of common stock under the Open Market Sale Agreement with Jefferies. There were no sales under the Open Market Sale Agreement during the six months ended June 30, 2012.

In March 2011, we commenced an offering of an aggregate of 3,500,000 shares of our senior common stock, par value \$0.001 per share, at a price to the public of \$15.00 per share, of which 3,000,000 shares are intended to be offered pursuant to the primary offering and 500,000 shares are intended to be offered pursuant to our senior common distribution reinvestment plan (the DRIP). We, however, reserve the right to reallocate the number of shares being offered between the primary offering and the DRIP. To date we have sold 38,133 shares of senior common stock in this ongoing offering.

**Table of Contents***Notes to Employees*

The following table is a summary of all outstanding notes issued to employees of the Adviser for the exercise of stock options:

Date Issued	Number of Options Exercised	Strike Price of Options Exercised	Amount of Promissory Note Issued to Employees	Outstanding Balance of Employee Loans at June 30, 2012	Outstanding Balance of Employee Loans at December 31, 2011	Maturity Date of Note	Interest Rate on Note
Sep 2004	25	\$ 15.00	\$ 375	\$ 5	\$ 11	Sep 2013	5.00%
Apr 2006	12	16.10	193	4	4	Apr 2015	7.77%
May 2006	2	16.10	32	32	32	May 2016	7.87%
Nov 2006	25	15.00	375	375	375	Nov 2015	8.15%
	64		\$ 975	\$ 416	\$ 422		

In accordance with ASC 505-10-45-2, Equity, receivables from employees for the issuance of capital stock to employees prior to the receipt of cash payment should be reflected in the balance sheet as a reduction to stockholders' equity. Therefore, these notes were recorded as full recourse loans to employees and are included in the equity section of the accompanying condensed consolidated balance sheets. As of June 30, 2012, each loan maintained its full recourse status.

**9. Subsequent Events**

On July 10, 2012, our Board of Directors declared the following monthly distributions:

Record Date	Payment Date	Common Stock Distributions per Share	Series A Preferred Distributions per Share	Series B Preferred Distributions per Share	Series C Preferred Distributions per Share
July 20, 2012	July 31, 2012	\$ 0.125	\$ 0.1614583	\$ 0.15625	\$ 0.1484375
August 22, 2012	August 31, 2012	\$ 0.125	\$ 0.1614583	\$ 0.15625	\$ 0.1484375
September 19, 2012	September 28, 2012	\$ 0.125	\$ 0.1614583	\$ 0.15625	\$ 0.1484375

**Senior Common Stock Distributions**

Payable to the

Holder or Record

During the Month of:	Payment Date	Distribution per Share
July	August 7, 2012	\$ 0.0875
August	September 10, 2012	\$ 0.0875
September	October 5, 2012	\$ 0.0875

On July 24, 2012, through a wholly-owned subsidiary, we borrowed \$9.8 million pursuant to a long-term note payable from American National Insurance Company, which is collateralized by a security interest in one of our properties. The note accrues interest at a rate of 5.6% per year and we may not repay this note during the first five years of the term; however, we may repay the note during the last five years of the term but we would be subject to a substantial prepayment penalty. The note has a maturity date of August 1, 2022. We intend to use the proceeds from the note for future acquisitions and working capital.

---

**Table of Contents**

**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations (Dollars in Thousands, Except Share and Per Share Data or Unless Otherwise Indicated)**

*All statements contained herein, other than historical facts, may constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, or the Exchange Act. These statements may relate to, among other things, future events or our future performance or financial condition. In some cases, you can identify forward-looking statements by terminology such as may, might, believe, will, provided, anticipate, future, could, growth, plan, intend, expect, should, would, if, seek, possible, potential, likely or the negative of such terms or comparable terminology. These forward-looking statements involve known and unknown risks, uncertainties and other factors that may cause our business, financial condition, liquidity, results of operations, funds from operations or prospects to be materially different from any future business, financial condition, liquidity, results of operations, funds from operations or prospects expressed or implied by such forward-looking statements. For further information about these and other factors that could affect our future results, please see the captions titled Risk Factors in this report and in our Annual Report on Form 10-K for the year ended December 31, 2011. We caution readers not to place undue reliance on any such forward-looking statements, which are made pursuant to the Private Securities Litigation Reform Act of 1995 and, as such, speak only as of the date made. We undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise, after the date of this Quarterly Report on Form 10-Q, or Report.*

*All references to we, our, us and the Company in this Report mean Gladstone Commercial Corporation and its consolidated subsidiaries, except where it is made clear that the term means only Gladstone Commercial Corporation.*

**OVERVIEW**

**General**

We are a real estate investment trust, or REIT, that was incorporated under the General Corporation Law of the State of Maryland on February 14, 2003, primarily for the purpose of investing in and owning net leased industrial, commercial and retail real property and selectively making long-term industrial and commercial mortgage loans. Our portfolio of real estate is leased to a wide cross section of tenants ranging from small businesses to large public companies, many of which are corporations that do not have publicly-rated debt. We have historically entered into, and intend in the future to enter into, purchase agreements for real estate having triple net leases with terms of approximately 10 to 15 years and built in rental rate increases. Under a triple net lease, the tenant is required to pay all operating, maintenance and insurance costs and real estate taxes with respect to the leased property. We actively communicate with buyout funds, real estate brokers and other third parties to locate properties for potential acquisition or to provide mortgage financing in an effort to build our portfolio. We currently own 77 properties totaling 7.6 million square feet, which have a total gross and net carrying value, including intangible assets, of \$549.2 million and \$464.9 million, respectively. We do not currently have any mortgage loans receivable outstanding.

**Business Environment**

The United States continues to feel the lingering impact of the recession that began in late 2007; while the unemployment rate has decreased over the last several months, it still remains higher than pre-recessionary levels. In addition, housing starts remain low, there continues to be a large inventory of homes that need to be sold, and the economic situation in Europe continues to be unpredictable and will need to stabilize for the economy to fully recover. As a result, conditions within the U.S. capital markets generally, and the U.S. real estate capital markets particularly, continue to experience certain levels of dislocation and stress.

## **Table of Contents**

These economic conditions could materially and adversely impact the financial condition of one or more of our tenants and, therefore, could increase the likelihood that a tenant may declare bankruptcy or default upon its payment obligations arising under a related lease. For example, the tenant occupying our building located in Hazelwood, Missouri declared bankruptcy in October 2010. The tenant did not confirm our lease in its bankruptcy proceedings in March 2011, and the final rent payment was received in April 2011. We are currently working to re-tenant this property. In addition, our building located in Richmond, Virginia remains vacant. The leases on these two vacant buildings comprised 2.0% of our annualized rental income as of June 30, 2012 and the annual carrying costs are \$0.2 million. We are actively seeking new tenants for these properties. All of our remaining properties are occupied and the tenants are paying in accordance with their leases.

Moreover, our ability to make new investments is highly dependent upon our ability to procure external financing. Our principal sources of external financing generally include the issuance of equity securities, long-term mortgage loans secured by properties and borrowings under our line of credit, or the Line of Credit. The market for long-term mortgages has been limited for some time; however, we have recently seen mid-to-long-term (5 to 10 year) mortgages become more obtainable. The collateralized mortgage backed securities, or CMBS, market has made a comeback in recent months, but it is more conservative and restrictive than it was prior to the recession and the pricing in the market remains somewhat volatile. Consequently, we continue to look primarily to regional banks, insurance companies and other non-bank lenders, and, to a lesser extent, the CMBS market to issue mortgages to finance our real estate activities.

Despite the challenges in the marketplace, we issued 2.2 million common shares during 2011 for gross proceeds of \$39.4 million. In addition, in January 2012 we issued \$38.5 million of 7.125% Series C Cumulative Term Preferred Stock, or Term Preferred Stock, which is mandatorily redeemable five years from issuance. We also assumed or issued \$31.7 million and \$33.7 million in mortgages from regional banks during 2011 and 2012, respectively, to finance some of our new properties.

## **Recent Developments**

### *Investment Activities*

The following is a summary of our recent acquisitions:

*Ashburn, Virginia:* On January 25, 2012, we acquired a 52,130 square foot office building located in Ashburn, Virginia for \$10.8 million, excluding related acquisition expenses of \$0.1 million. We funded this acquisition using borrowings from our Line of Credit. Independent Project Analysis, Inc., an energy consultant, is the tenant in this building and has leased the property for 15 years and has 2 options to renew the lease for additional periods of 5 years each. The lease provides for prescribed rent escalations over the life of the lease, with annualized straight line rents of \$1.0 million.

*Ottumwa, Iowa:* On May 30, 2012, we acquired a 352,860 square foot bottling plant located in Ottumwa, Iowa for \$7.1 million, excluding related acquisition expenses of \$0.1 million. We funded this acquisition through a combination of cash on hand and the issuance of \$5.0 million of mortgage debt on the property. The American Bottling Company, the largest operating subsidiary of Dr Pepper Snapple Group, Inc., is the tenant in this building and has leased the property for 12 years and has 3 options to renew the lease for additional periods of 5 years each. The lease provides for prescribed rent escalations over the life of the lease, with annualized straight line rents of \$0.68 million.

*New Albany, Ohio:* On June 5, 2012, we acquired an 89,000 square foot office building located in New Albany, Ohio for \$13.3 million, excluding related acquisition expenses of \$0.2 million. We funded this acquisition with existing cash on hand. Commercial Vehicle Group, Inc., a global supplier of fully integrated interiors system solutions for the global commercial vehicle market, is the tenant in this building and has leased the property for 10.5 years and has 2 options to renew the lease for additional periods of 5 years each. The lease provides for prescribed rent escalations over the life of the lease, with annualized straight line rents of \$1.36 million.



## **Table of Contents**

*Columbus, Georgia:* On June 21, 2012, we acquired a 32,000 square foot office and classroom facility located in Columbus, Georgia for \$7.3 million, excluding related acquisition expenses of \$0.1 million. We funded this acquisition through a combination of cash on hand and the issuance of \$4.8 million of mortgage debt on the property. University of Phoenix, a private education provider, which has been in the education business for more than 35 years, is the tenant in this building and has leased the property for 11.5 years and has 2 options to renew the lease for additional periods of 5 years each. The lease provides for prescribed rent escalations over the life of the lease, with annualized straight line rents of \$0.66 million.

*Columbus, Ohio:* On June 28, 2012, we acquired a 31,293 square foot office building located in Columbus, Ohio for \$4.0 million, excluding related acquisition expenses of \$0.1 million. We funded this acquisition with existing cash on hand. Nationwide Children's Hospital, one of the largest children's hospital systems in the United States, is the tenant in this building and has leased the property for 10 years. The lease provides for prescribed rent escalations over the life of the lease, with annualized straight line rents of \$0.34 million.

### *Financing Activities*

#### Line of Credit

*Expansion:* On January 31, 2012, we amended our Line of Credit to increase the current maximum availability of credit thereunder from \$50.0 million to \$75.0 million. The Line of Credit was arranged by Capital One, N.A. as administrative agent, and Branch Banking and Trust Company as an additional lender. Citizens Bank of Pennsylvania joined the Line of Credit as an additional lender. All other terms of the agreement remained the same.

#### Debt

*KeyBank:* On April 5, 2012, through wholly-owned subsidiaries, we borrowed \$19.0 million pursuant to a long-term note payable from KeyBank National Association, which is collateralized by security interests in four of our properties. The note accrues interest at a rate of 6.1% per year and we may not repay this note prior to the last three months of the term, or we would be subject to a substantial prepayment penalty. The note has a maturity date of May 1, 2022. We intend to use the proceeds from the note for future acquisitions and working capital.

*City National Bank:* On May 16, 2012, through a wholly-owned subsidiary, we borrowed \$2.94 million pursuant to a long-term note payable from City National Bank, which is collateralized by a security interest in one of our properties. The note accrues interest at a rate of 4.3% per year for the first five years, and resets at five year intervals thereafter. We may repay this note after five years and would not be subject to any prepayment penalty. The note has a maturity date of December 31, 2026. We intend to use the proceeds from the note for future acquisitions and working capital.

*Modern Woodmen of America:* On May 30, 2012, through a wholly-owned subsidiary, we borrowed \$5.0 million pursuant to a long-term note payable from Modern Woodmen of America, which is collateralized by a security interest in one of our properties. The note accrues interest at a rate of 6.5% per year and we may not repay this note prior to the last six months of the term, or we would be subject to a substantial prepayment penalty. The note has a maturity date of May 10, 2027. We intend to use the proceeds from the note for future acquisitions and working capital.

*Citigroup:* On June 21, 2012, through a wholly-owned subsidiary, we borrowed \$4.75 million pursuant to a long-term note payable from Citigroup, which is collateralized by a security interest in one of our properties. The note accrues interest at a rate of 5.05% per year and we may not repay this note prior to the last two months of the term, or we would be subject to a substantial prepayment penalty. The note has a maturity date of July 6, 2022. We intend to use the proceeds from the note for future acquisitions and working capital.

## **Table of Contents**

*American Equity Investment Life Insurance Company:* On June 27, 2012, through a wholly-owned subsidiary, we borrowed \$2.0 million pursuant to a long-term note payable from American Equity Investment Life Insurance Company, which is collateralized by a security interest in one of our properties. The note accrues interest at a rate of 5.1% per year and we may not repay this note prior to the last five years of the term, or we would be subject to a substantial prepayment penalty. The note has a maturity date of July 1, 2029. We intend to use the proceeds from the note for future acquisitions and working capital.

*American National Insurance Company:* On July 24, 2012, through a wholly-owned subsidiary, we borrowed \$9.8 million pursuant to a long-term note payable from American National Insurance Company, which is collateralized by a security interest in one of our properties. The note accrues interest at a rate of 5.6% per year and we may not repay this note during the first five years of the term; however, we may repay the note during the last five years of the term but we would be subject to a substantial prepayment penalty. The note has a maturity date of August 1, 2022. We intend to use the proceeds from the note for future acquisitions and working capital.

### *Leasing Activities*

The following is a summary of leases that have been recently extended:

*South Hadley, Massachusetts:* On February 13, 2012, the tenant in our building located in South Hadley, Massachusetts signed a new lease with a term expiring in January 2013, with a one-year extension option.

*San Antonio, Texas:* On February 14, 2012, we extended the lease with the tenant occupying our property located in San Antonio, Texas. The lease covering this property was extended for an additional eight-year period, through November 2021. The lease was originally set to expire in February 2014. The lease provides for prescribed rent escalations over the life of the lease, with annualized straight line rents of approximately \$0.8 million. Furthermore, the lease grants the tenant two options to extend the lease for a period of five years each. In connection with the extension of the lease and the modification of certain terms under the lease, we provided a tenant allowance of \$0.6 million, payable over two years, and paid \$0.3 million in leasing commissions.

*Roseville, Minnesota:* On February 27, 2012, we extended the lease with the tenant occupying our property located in Roseville, Minnesota. The new lease covers approximately one-third of this property and was extended for an additional five year period, through December 2017. The lease was originally set to expire in December 2012. The tenant in this property will pay rent on the entire building through the end of 2012, and we continue to search for new tenants to lease the remainder of the building. The new lease provides for prescribed rent escalations over the life of the lease, with annualized straight line rents of \$1.2 million. Furthermore, the lease grants the tenant one option to extend the lease for a period of five years. In connection with the extension of the lease and the modification of certain terms under the lease, we provided a tenant allowance of \$0.4 million, payable over two years, and paid \$0.8 million in leasing commissions.

*Hialeah, Florida:* On June 29, 2012, we extended the lease with the tenant occupying our property located in Hialeah, Florida. The lease covering this property was extended for an additional five-year period, through March 2027. The lease was originally set to expire in March 2022. The lease provides for prescribed rent escalations over the life of the lease, with annualized straight line rents of approximately \$1.1 million. In connection with the extension of the lease and the modification of certain terms under the lease, we provided a tenant allowance of \$0.3 million.

## **Table of Contents**

### *Equity Activities*

The equity issuances summarized below were all issued under our effective shelf registration statement on file with the Securities and Exchange Commission, or SEC.

*Preferred Equity:* In February 2012, we completed a public offering of 1,540,000 shares of our Term Preferred Stock at a public offering price of \$25.00 per share. Gross proceeds of the offering totaled \$38.5 million and net proceeds, after deducting underwriting discounts and offering expenses borne by us, were \$36.7 million and were used to repay a portion of outstanding borrowings under our Line of Credit, for acquisitions of real estate and working capital. The shares are traded under the ticker symbol GOODN on the NASDAQ. The Term Preferred Stock is not convertible into our common stock or any other security. Generally, we may not redeem shares of the Term Preferred Stock prior to January 31, 2016, except in limited circumstances to preserve our status as a REIT. On or after January 31, 2016, we may redeem the shares at a redemption price of \$25.00 per share, plus any accumulated and unpaid dividends to and including the date of redemption. The shares of the Term Preferred Stock have a mandatory redemption date of January 31, 2017. In accordance with ASC 480, Distinguishing Liabilities from Equity, mandatorily redeemable financial instruments should be classified as liabilities in the balance sheet and therefore we recorded the Term Preferred Stock as a liability and the related dividend payments as a component of interest expense in the statement of operations.

*Senior Common Equity:* During 2011 and 2012, we have issued 38,133 shares of our senior common stock at \$15.00 per share in an ongoing best-efforts public offering. The net proceeds, after deducting the underwriting discount and commission were \$0.5 million. We can issue up to 3,000,000 shares of senior common stock and the offering will continue until the earlier of March 28, 2013 or the date on which 3,000,000 shares of senior common stock are sold. We have used the proceeds of the offering for general corporate purposes.

### **Diversity of Our Portfolio**

Gladstone Management Corporation, or our Adviser, seeks to diversify our portfolio to avoid dependence on any one particular tenant, industry or geographic market. By diversifying our portfolio, our Adviser intends to reduce the adverse effect on our portfolio of a single under-performing investment or a downturn in any particular industry or geographic market. The table below reflects the breakdown of our total rental income by tenant industry classification for the six months ended June 30, 2012 and 2011, respectively:

**Table of Contents**

Industry Classification	For the six months ended June 30, 2012 (Dollars in Thousands)		For the six months ended June 30, 2011 (Dollars in Thousands)	
	Rental Income	Percentage of Rental Income	Rental Income	Percentage of Rental Income
Telecommunications	\$ 3,636	14.8%	\$ 2,768	13.1%
Electronics	3,091	12.7	3,083	14.6
Healthcare	2,496	10.3	1,995	9.3
Diversified/Conglomerate Manufacturing	1,832	7.5	1,832	8.6
Chemicals, Plastics & Rubber	1,576	6.5	1,569	7.3
Beverage, Food & Tobacco	1,279	5.3	1,094	5.2
Personal & Non-Durable Consumer Products	1,217	5.0	1,116	5.3
Containers, Packaging & Glass	1,171	4.8	1,166	5.5
Machinery	1,130	4.6	1,126	5.3
Buildings and Real Estate	1,068	4.4	1,052	5.0
Printing & Publishing	947	3.9	1,033	4.9
Education	915	3.8	888	4.2
Personal, Food & Miscellaneous Services	907	3.7	288	1.4
Automobile	682	2.8	583	2.8
Oil & Gas	635	2.6	635	3.0
Diversified/Conglomerate Services	622	2.6	379	1.8
Banking	575	2.4		0.0
Childcare	292	1.2	292	1.4
Home & Office Furnishings	265	1.1	265	1.3
	\$ 24,336	100.0%	\$ 21,164	100.0%

The table below reflects the breakdown of our total rental income for our five largest tenants for the six months ended June 30, 2012 and 2011, respectively:

Location	Rental Revenue for the six months ended June 30, 2012 (Dollars in Thousands)		% of Base Rent
Roseville, MN	\$ 1,636	6.7%	
Duncan, SC	960	3.9%	
Concord Township, OH	862	3.5%	
Multiple Locations, GA	824	3.4%	
Tulsa, OK	783	3.2%	
All Other Tenants	19,271	79.3%	
<b>Total</b>	<b>\$ 24,336</b>	<b>100%</b>	

The table below reflects the breakdown of our total rental income by state for the six months ended June 30, 2012 and 2011, respectively:

State	Number of Leases	Rental Revenue for the six months ended June 30, 2012 (Dollars in Thousands)		% of Base Rent
Ohio	14	\$ 3,981	16.4%	
Minnesota	3	2,660	10.9%	
North Carolina	7	2,390	9.8%	

Edgar Filing: GLADSTONE COMMERCIAL CORP - Form 10-Q

Pennsylvania	5	1,719	7.1%
Massachusetts	4	1,345	5.5%
All Other States	29	12,241	50.3%
<b>Total</b>	<b>62</b>	<b>\$ 24,336</b>	<b>100%</b>

## **Table of Contents**

### **Our Adviser and Administrator**

Our Adviser is led by a management team which has extensive experience purchasing real estate and originating mortgage loans. Our Adviser is controlled by Mr. David Gladstone, our chairman and chief executive officer. Mr. Gladstone is also the chairman and chief executive officer of our Adviser. Terry Lee Brubaker, our co-vice chairman, chief operating officer, secretary and director, is a member of the Board of Directors of our Adviser as well as its vice chairman and chief operating officer. George Stelljes III, our co-vice chairman, chief investment officer and director, is a member of the Board of Directors of our Adviser and its president and chief investment officer. Gladstone Administration, LLC, or our Administrator, employs our chief financial officer and treasurer, chief compliance officer, internal counsel, investor relations department and their respective staffs.

Our Adviser and Administrator also provide investment advisory and administrative services, respectively, to our affiliates, including, but not limited to, Gladstone Capital Corporation and Gladstone Investment Corporation, both publicly-traded business development companies, as well as Gladstone Land Corporation, a private agricultural real estate company. With the exception of Danielle Jones, our chief financial officer and treasurer, and Robert Cutlip, our president, all of our executive officers serve as either directors or executive officers, or both, of Gladstone Capital Corporation and Gladstone Investment Corporation. In the future, our Adviser may provide investment advisory services to other funds, both public and private, of which it is the sponsor.

### **Advisory and Administration Agreements**

We are externally managed pursuant to contractual arrangements with our Adviser and our Administrator. Our Adviser and Administrator employ all of our personnel and pay their payroll, benefits, and general expenses directly. We have an advisory agreement with our Adviser, or the Advisory Agreement, and an administration agreement with our Administrator, or the Administration Agreement.

Under the terms of the Advisory Agreement, we are responsible for all expenses incurred for our direct benefit. Examples of these expenses include legal, accounting, interest on short-term debt and mortgages, tax preparation, directors and officers insurance, stock transfer services, stockholder-related fees, consulting and related fees. In addition, we are also responsible for all fees charged by third parties that are directly related to our business, which may include real estate brokerage fees, mortgage placement fees, lease-up fees and transaction structuring fees (although we may be able to pass some or all of such fees on to our tenants and borrowers).

During the six months ended June 30, 2012 and 2011, none of these third party expenses were incurred by us directly. The actual amount of such fees that we incur in the future will depend largely upon the aggregate costs of the properties that we acquire, the aggregate amount of mortgage loans that we make and the extent to which we are able to pass on such fees to our tenants and borrowers pursuant to the terms of the agreements. Accordingly, the amount of these fees that we will pay in the future is not determinable at this time.

#### *Management Services and Fees under the Advisory Agreement*

The Advisory Agreement provides for an annual base management fee equal to 2.0% of our total stockholders' equity, less the recorded value of any preferred stock, or total common stockholders' equity, and for an incentive fee based on funds from operations, or FFO. Our Adviser does not charge acquisition or disposition fees when we acquire or dispose of properties as is common with other externally-advised REITs. Furthermore, there are no fees charged when our Adviser secures long or short term credit or arranges mortgage loans on our properties; however, our Adviser may earn fee income from our borrowers or tenants or other sources.

## **Table of Contents**

For purposes of calculating the incentive fee, FFO includes any realized capital gains and capital losses, less any distributions paid on preferred stock and senior common stock, but FFO does not include any unrealized capital gains or losses. The incentive fee would reward our Adviser if our quarterly FFO, before giving effect to any incentive fee, or pre-incentive fee FFO, exceeds 1.75%, or the hurdle rate, of total common stockholders' equity. We pay our Adviser an incentive fee with respect to our pre-incentive fee FFO in each calendar quarter as follows:

no incentive fee in any calendar quarter in which our pre-incentive fee FFO does not exceed the hurdle rate of 1.75% (7% annualized);

100% of the amount of the pre-incentive fee FFO that exceeds the hurdle rate, but is less than 2.1875% in any calendar quarter (8.75% annualized); and

20% of the amount of our pre-incentive fee FFO that exceeds 2.1875% in any calendar quarter (8.75% annualized).  
*Quarterly Incentive Fee Based on FFO*

Pre-incentive fee FFO

(expressed as a percentage of total common stockholders' equity)

Percentage of pre-incentive fee FFO allocated to the incentive fee

The incentive fee may be reduced because of a covenant which exists in our Line of Credit agreement which limits distributions to our stockholders to 95% of FFO with acquisition-related costs that are required to be expensed under Accounting Standards Codification, or ASC, 805, Business Combinations added back to FFO. In order to comply with this covenant, our Board of Directors accepted our Adviser's offer to unconditionally, irrevocably and voluntarily waive on a quarterly basis a portion of the incentive fee for the three and six months ended June 30, 2012 and 2011, which allowed us to maintain the current level of distributions to our stockholders. These waived fees may not be recouped by our Adviser in the future. Our Adviser has indicated that it intends to continue to waive all or a portion of the incentive fee in order to support the current level of distributions to our stockholders; however, our Adviser is not required to issue any such waiver, either in whole or in part.

### *Administration Agreement*

Pursuant to the Administration Agreement, we pay for our allocable portion of our Administrator's overhead expenses incurred while performing its obligations to us, including, but not limited to, rent and the salaries and benefits expenses of our personnel, including our chief financial officer and treasurer, chief compliance officer, internal counsel, investor relations department and their respective staffs. Our allocable portion of expenses is generally derived by multiplying our Administrator's total expenses by the percentage of our total assets at the beginning of each quarter in comparison to the total assets of all companies managed by our Adviser under similar agreements.

### **Critical Accounting Policies**

The preparation of our financial statements in accordance with generally accepted accounting principles in the United States of America, or GAAP, requires management to make judgments that are subjective in nature in order to make certain estimates and assumptions. Our Adviser relies on its experience, collects historical and current market data and analyzes this information in order to arrive at what it believes to be

**Table of Contents**

reasonable estimates. Under different conditions or assumptions, materially different amounts could be reported related to the accounting policies described below. In addition, application of these accounting policies involves the exercise of judgment regarding the use of assumptions as to future uncertainties, and as a result, actual results could materially differ from these estimates. A summary of all of our significant accounting policies is provided in Note 1 to our condensed consolidated financial statements included elsewhere in this Form 10-Q. Below is a summary of accounting policies involving estimates and assumptions that require complex, subjective or significant judgments in their application and that materially affect our results of operations.



## **Table of Contents**

### *Allocation of Purchase Price*

When we acquire real estate, we allocate the purchase price to (i) the acquired tangible assets and liabilities, consisting of land, building, tenant improvements, long-term debt and (ii) the identified intangible assets and liabilities, consisting of the value of above-market and below-market leases, in-place leases, unamortized lease origination costs, tenant relationships and capital lease obligations, based in each case on their fair values. All expenses related to the acquisition are expensed as incurred, rather than capitalized into the cost of the acquisition as had been required by the previous accounting.

Management's estimates of value are made using methods similar to those used by independent appraisers (e.g., discounted cash flow analysis). Factors considered by management in its analysis include an estimate of carrying costs during hypothetical expected lease-up periods, considering current market conditions and costs to execute similar leases. We also consider information obtained about each property as a result of our pre-acquisition due diligence, marketing and leasing activities in estimating the fair value of the tangible and intangible assets and liabilities acquired. In estimating carrying costs, management also includes real estate taxes, insurance and other operating expenses and estimates of lost rentals at market rates during the hypothetical expected lease-up periods, which primarily range from 9 to 18 months, depending on specific local market conditions. Management also estimates costs to execute similar leases, including leasing commissions, legal and other related expenses to the extent that such costs are not already incurred in connection with a new lease origination as part of the transaction. Management also considers the nature and extent of our existing business relationships with the tenant, growth prospects for developing new business with the tenant, the tenant's credit quality and management's expectations of lease renewals (including those existing under the terms of the lease agreement), among other factors. A change in any of the assumptions above, which are very subjective, could have a material impact on our results of operations.

The allocation of the purchase price directly affects the following in our condensed consolidated financial statements:

The amount of purchase price allocated to the various tangible and intangible assets on our balance sheet;

The amounts allocated to the value of above-market and below-market lease values are amortized to rental income over the remaining non-cancelable terms of the respective leases. The amounts allocated to all other tangible and intangible assets are amortized to depreciation or amortization expense. Thus, depending on the amounts allocated between land and other depreciable assets, changes in the purchase price allocation among our assets could have a material impact on our FFO, a metric which is used by many REIT investors to evaluate our operating performance; and

The period of time over which tangible and intangible assets are depreciated varies greatly, and thus, changes in the amounts allocated to these assets will have a direct impact on our results of operations. Intangible assets are generally amortized over the respective life of the leases, which normally range from 10 to 15 years. Also, we depreciate our buildings over 39 years, but do not depreciate our land. These differences in timing could have a material impact on our results of operations.

### *Asset Impairment Evaluation*

We periodically review the carrying value of each property to determine if circumstances that indicate impairment in the carrying value of the investment exist or that depreciation periods should be modified. In determining if impairment exists, management considers such factors as our tenants' payment histories, the financial condition of our tenants, including calculating the current leverage ratios of tenants, the likelihood of lease renewal, business conditions in the industries in which our tenants operate and whether the carrying value of our real estate has decreased. If any of the factors above support the possibility of impairment, we prepare a projection of the undiscounted future cash flows, without interest charges, of the specific property and determine if the carrying amount of such property is recoverable. In preparing the projection of undiscounted future cash flows, we estimate the holding periods of the properties and cap rates using information that we obtain from market comparability studies and other comparable sources. If

## **Table of Contents**

impairment were indicated, the carrying value of the property would be written down to its estimated fair value based on our best estimate of the property's discounted future cash flows using assumptions from market participants. Any material changes to the estimates and assumptions used in this analysis could have a significant impact on our results of operations, as the changes would impact our determination of whether impairment is deemed to have occurred and the amount of impairment loss that we would recognize.

Using the methodology discussed above and in light of the current economic conditions discussed above in *Overview-Business Environment*, we evaluated our entire portfolio as of June 30, 2012 for any impairment indicators and performed an impairment analysis on those select properties that had an indication of impairment. As a result of this analysis, we concluded that none of our properties were impaired and we will continue to monitor our portfolio for any indicators that may change our conclusion.

## **Results of Operations**

The weighted-average yield on our total portfolio, taking into account vacant properties, was 9.2% as of June 30, 2012. If all properties in the portfolio were fully occupied, the weighted-average yield would have been 9.4%, assuming returns on our vacant buildings remained consistent, as of June 30, 2012. The weighted-average yield on our portfolio is calculated by taking the annualized straight-line rents, reflected as rental income on our condensed consolidated statements of operations, of each acquisition as a percentage of the acquisition. The weighted-average yield does not account for the interest expense incurred on the mortgages placed on our properties.

**Table of Contents**

A comparison of our operating results for the three and six months ended June 30, 2012 and 2011 is below:

	2012	For the three months ended June 30, 2011	\$ Change	% Change
	(Dollars in Thousands)			
<b>Operating revenues</b>				
Rental income	\$ 12,323	\$ 10,729	\$ 1,594	15%
Tenant recovery revenue	87	87		0%
<b>Total operating revenues</b>	<b>12,410</b>	<b>10,816</b>	<b>1,594</b>	<b>15%</b>
<b>Operating expenses</b>				
Depreciation and amortization	3,992	3,475	517	15%
Property operating expenses	353	202	151	75%
Due diligence expense	528	131	397	303%
Base management fee	372	435	(63)	-14%
Incentive fee	787	840	(53)	-6%
Administration fee	265	260	5	2%
General and administrative	404	357	47	13%
<b>Total operating expenses before credit from Adviser</b>	<b>6,701</b>	<b>5,700</b>	<b>1,001</b>	<b>18%</b>
Credit to incentive fee	(674)	(445)	(229)	51%
<b>Total operating expenses</b>	<b>6,027</b>	<b>5,255</b>	<b>772</b>	<b>15%</b>
<b>Other income (expense)</b>				
Interest income employee loans	8	9	(1)	-11%
Other income	34	1	33	NM
Interest expense	(4,885)	(4,201)	684	16%
Distributions attributable to mandatorily redeemable preferred stock	(686)	0	686	NM
<b>Total other expense</b>	<b>(5,529)</b>	<b>(4,191)</b>	<b>(1,338)</b>	<b>32%</b>
<b>Net income</b>	<b>854</b>	<b>1,370</b>	<b>(516)</b>	<b>-38%</b>
Distributions attributable to preferred stock	(1,024)	(1,024)		0%
Distributions attributable to senior common stock	(22)	(15)	(7)	47%
<b>Net income available to common stockholders</b>	<b>\$ (192)</b>	<b>\$ 331</b>	<b>\$ (523)</b>	<b>-158%</b>
Net income available to common stockholders per weighted average share of common stock diluted	\$ (0.02)	\$ 0.04	\$ (0.06)	-158%
<b>FFO available to common stockholders</b>	<b>\$ 3,800</b>	<b>\$ 3,806</b>	<b>\$ (6)</b>	<b>0%</b>
Diluted FFO per weighted average share of common stock	\$ 0.35	\$ 0.39	\$ (0.04)	-11%

NM = Not meaningful

**Table of Contents**

	2012	For the six months ended June 30,		
		2011	\$ Change	% Change
		(Dollars in Thousands)		
<b>Operating revenues</b>				
Rental income	\$ 24,336	\$ 21,164	\$ 3,172	15%
Tenant recovery revenue	171	170	1	1%
<b>Total operating revenues</b>	<b>24,507</b>	<b>21,334</b>	<b>3,173</b>	<b>15%</b>
<b>Operating expenses</b>				
Depreciation and amortization	7,896	6,845	1,051	15%
Property operating expenses	686	499	187	37%
Due diligence expense	688	(8)	696	NM
Base management fee	765	787	(22)	-3%
Incentive fee	1,686	1,672	14	1%
Administration fee	575	516	59	11%
General and administrative	787	812	(25)	-3%
<b>Total operating expenses before credit from Adviser</b>	<b>13,083</b>	<b>11,123</b>	<b>1,960</b>	<b>18%</b>
Credit to incentive fee	(1,259)	(931)	328	35%
<b>Total operating expenses</b>	<b>11,824</b>	<b>10,192</b>	<b>1,632</b>	<b>16%</b>
<b>Other income (expense)</b>				
Interest income employee loans	17	19	(2)	-11%
Other income	56	45	11	24%
Interest expense	(9,458)	(8,356)	1,102	13%
Distributions attributable to mandatorily redeemable preferred stock	(1,143)	0	1,143	NM
<b>Total other expense</b>	<b>(10,528)</b>	<b>(8,292)</b>	<b>(2,236)</b>	<b>27%</b>
<b>Net income</b>	<b>2,155</b>	<b>2,850</b>	<b>(695)</b>	<b>-24%</b>
Distributions attributable to preferred stock	(2,047)	(2,047)		0%
Distributions attributable to senior common stock	(41)	(31)	10	32%
<b>Net income available to common stockholders</b>	<b>\$ 67</b>	<b>\$ 772</b>	<b>\$ (705)</b>	<b>-91%</b>
Net income available to common stockholders per weighted average share of common stock diluted	0.01	\$ 0.08	\$ (0.07)	-92%
<b>FFO available to common stockholders</b>	<b>\$ 7,963</b>	<b>\$ 7,617</b>	<b>\$ 346</b>	<b>5%</b>
Diluted FFO per weighted average share of common stock	\$ 0.73	\$ 0.80	\$ (0.07)	-8%

NM = Not meaningful

*Operating Revenues*

Rental income increased for both the three and six months ended June 30, 2012, as compared to the three and six months ended June 30, 2011, because of the 10 properties acquired subsequent to June 30, 2011.

Tenant recovery revenue remained relatively flat for the three and six months ended June 30, 2012, as compared to the three and six months ended June 30, 2011. There was an increase in insurance premiums from 2011, resulting in increased reimbursements from our tenants;

however, this was partially offset by a decrease in franchise taxes owed in certain states that are reimbursable by our tenants.

*Operating Expenses*

Depreciation and amortization expenses increased for the three and six months ended June 30, 2012, as compared to the three and six months ended June 30, 2011, because of the 10 properties acquired subsequent to June 30, 2011.

Property operating expenses consist of franchise taxes, management fees, insurance, ground lease payments and overhead expenses paid on behalf of certain of our properties. Property operating expenses increased for both the three and six months ended June 30, 2012, as compared to the three and six months ended June 30, 2011, primarily because of ground lease payments we are responsible for paying at two of our properties acquired subsequent to June 30, 2011.

## Table of Contents

Due diligence expense primarily consists of legal fees and fees incurred for third-party reports prepared in connection with potential acquisitions and our due diligence analyses related thereto. Due diligence expense increased for both the three and six months ended June 30, 2012, as compared to the three and six months ended June 30, 2011, as a result of costs incurred related to the five properties acquired during the six months ended June 30, 2012 coupled with costs incurred for other potential acquisitions, partially offset by an out of period adjustment of \$250,000 recorded during the six months ended June 30, 2011, related to the acquisition of the property in Orange City, Iowa in December 2010. See Note 1 to our condensed consolidated financial statements included elsewhere in this Form 10-Q for further information regarding the out of period adjustment.

The base management fee decreased for the three and six months ended June 30, 2012, as compared to the three and six months ended June 30, 2011, due to a decrease in total common stockholders' equity, the main component of the calculation. The calculation of the base management fee is described in detail above under *Advisory and Administration Agreements*.

The incentive fee decreased for the three months ended June 30, 2012, as compared to the three months ended June 30, 2011, because of a decrease in pre-incentive fee FFO due to an increase in property operating, due diligence and interest expense, partially offset by an increase in rental revenues during the quarter ended June 30, 2012, as compared to the quarter ended June 30, 2011. The incentive fee increased slightly for the six months ended June 30, 2012, as compared to the six months ended June 30, 2011, because of an increase in pre-incentive fee FFO due to an increase in rental revenues from the 10 acquisitions made over the past twelve months, partially offset by an increase in property operating, due diligence and interest expense during the six months ended June 30, 2012, as compared to the six months ended June 30, 2011.

The incentive fee credit increased for both the three and six months ended June 30, 2012, as compared to the three and six months ended June 30, 2011, because of the increase in the amount of common stock dividends paid during the six months ended June 30, 2012, which resulted in a larger portion of the incentive fee required to be credited. The calculation of the incentive fee is described in the detail above under *Advisory and Administration Agreements*.

The administration fee increased for both the three and six months ended June 30, 2012, as compared to the three and six months ended June 30, 2011, primarily as a result of an increase in the amount of the total expenses our Administrator incurred during the periods, coupled with an increase in our allocable portion of the total expenses. The calculation of the administration fee is described in detail above under *Advisory and Administration Agreements*.

General and administrative expenses increased for the three months ended June 30, 2012, as compared to the three months ended June 30, 2011, primarily due to timing of expenses related to our annual report and proxy. General and administrative expenses decreased for the six months ended June 30, 2012, as compared to the six months ended June 30, 2011, primarily due to a decrease in tax preparation fees during the six months ended June 30, 2012.

### *Other Income and Expense*

Interest income on employee loans decreased during the three and six months ended June 30, 2012, as compared to the three and six months ended June 30, 2011. This decrease was a result of principal repayments made by employees of our Adviser over the past 12 months.

Other income increased during the three and six months ended June 30, 2012, as compared to the three and six months ended June 30, 2011, because of an easement payment received in 2012 related to our property located in Sterling Heights, Michigan.

Interest expense increased for both the three and six months ended June 30, 2012, as compared to the three and six months ended June 30, 2011. This increase was primarily a result of interest on the \$53.5 million of mortgage debt assumed and issued during the last 12 months, partially offset by reduced interest expense on our long-term financings from amortizing principal payments made during the last 12 months.

## **Table of Contents**

### *Net (Loss) Income Available to Common Stockholders*

Net (loss) income available to common stockholders decreased for both the three and six months ended June 30, 2012, as compared to the three and six months ended June 30, 2011, primarily because of increased interest expense and increased distributions to our preferred stockholders from the issuance of our Term Preferred Stock, partially offset by an increase in rental income earned from the 10 properties acquired subsequent to June 30, 2011.

## **Liquidity and Capital Resources**

### *Overview*

Our sources of liquidity include cash flows from operations, cash and cash equivalents, borrowings under our Line of Credit, obtaining mortgages on our unencumbered properties and issuing additional equity securities. Our available liquidity at June 30, 2012, was \$26.4 million, including \$4.3 million in cash and cash equivalents and an available borrowing capacity of \$22.1 million under our Line of Credit.

### *Future Capital Needs*

We actively seek conservative investments that are likely to produce income in order to pay distributions to our stockholders. We intend to use the proceeds of future equity raised and debt capital borrowed to continue to invest in industrial, commercial and retail real property, make mortgage loans, or pay down outstanding borrowings under our Line of Credit. Accordingly, to ensure that we are able to effectively execute our business strategy, we routinely review our liquidity requirements and continually evaluate all potential sources of liquidity. Our short-term liquidity needs include proceeds necessary to fund our distributions to stockholders, pay the debt service costs on our existing long-term mortgages, and fund our current operating costs. Our long-term liquidity needs include proceeds necessary to grow and maintain our portfolio of investments.

We believe that our available liquidity is sufficient to fund our distributions to stockholders, pay the debt service costs on our existing long-term mortgages and fund our current operating costs in the near term. We further believe that our cash flow from operations coupled with the financing capital available to us in the future are sufficient to fund our long-term liquidity needs. Additionally, to satisfy either our short-term or long-term obligations, or both, we may require credits to our management fees that are issued from our Adviser, although our Adviser is under no obligation to provide any such credits, either in whole or in part.

### *Equity Capital*

Equity capital markets continue to improve. As a result, we raised, net of offering costs, \$37.0 million of common equity during 2011. We also raised \$36.7 million of preferred equity, net of offering costs, in February 2012. We used these proceeds to repay a portion of the outstanding balance of the Line of Credit, to acquire additional properties and the remainder for general corporate and working capital needs.

Currently, we have the ability to raise up to \$218.1 million of additional equity capital through the sale of securities that are registered under our universal shelf registration statement on Form S-3, or the Universal Shelf, in one or more future public offerings. Of the \$218.1 million of available capacity under our Universal Shelf, \$21.6 million of common stock is reserved for additional sales under our Open Market Sale Agreement and \$51.9 million is reserved for sales of our senior common stock.

## **Table of Contents**

### *Debt Capital*

As of June 30, 2012, we had 25 fixed-rate mortgage notes payable in the aggregate principal amount of \$314.8 million, collateralized by a total of 66 properties with terms at issuance ranging from 2 years to 25 years. The weighted-average interest rate on the mortgage notes payable as of June 30, 2012 was 5.72%.

Generally, banks are recommencing their lending practices and the CMBS market is slowly returning, see the discussion in *Overview Business Environment* above. Specifically, we are seeing banks and other non-bank lenders that are willing to issue medium to long-term mortgages, between 5 and 10 years, albeit on less favorable terms than were previously available. Consequently, we are focused on obtaining mortgages through regional banks, non-bank lenders and CMBS.

We have mortgage debt in the aggregate principal amount of \$2.4 million payable during the remainder of 2012 and \$58.9 million payable during 2013. The 2012 principal amount payable does not include \$45.2 million of balloon principal payments maturing on one of our long-term mortgages in 2012; however, this mortgage has one remaining annual extension option through 2013, and we intend to either exercise this option in 2012 or refinance the pool for a longer term. As long as we are in compliance with certain covenants under the mortgage loan, we will be able to exercise the renewal option and will be required to pay a fee of 0.25% of the current outstanding principal balance, or approximately \$0.1 million. The mortgage payments due in 2012 are solely comprised of debt amortization payments. We have no balloon principal payments due under any of our other mortgage loans until 2013 and these are not due until the fourth quarter of 2013; however, we are initiating conversations with lenders in advance of these maturities and anticipate being able to extend the maturity dates or refinance with new lenders. We intend to pay the 2012 debt amortization payments from operating cash flow and borrowings under our Line of Credit.

### *Operating Activities*

Net cash provided by operating activities during the six months ended June 30, 2012, was \$10.8 million, as compared to net cash provided by operating activities of \$9.6 million for the six months ended June 30, 2011. This increase was primarily a result of rental income received from the 10 properties acquired subsequent to June 30, 2011, partially offset by \$1.1 million of leasing commissions paid for renewing existing leases. The majority of cash from operating activities is generated from the rental payments that we receive from our tenants. We utilize this cash to fund our property-level operating expenses and use the excess cash primarily for debt and interest payments on our mortgage notes payable, interest payments on our Line of Credit, distributions to our stockholders, management fees to our Adviser, and other entity-level expenses.

### *Investing Activities*

Net cash used in investing activities during the six months ended June 30, 2012, was \$46.3 million, which primarily consisted of the acquisition of five properties during the six months ended June 30, 2012, coupled with tenant improvements performed at certain of our properties and net payments to our lenders for reserves, as compared to net cash used in investing activities during the six months ended June 30, 2011, of \$16.4 million, which primarily consisted of the acquisition of two properties, coupled with tenant improvements performed at certain of our properties and net payments to our lenders for reserves.

### *Financing Activities*

Net cash provided by financing activities during the six months ended June 30, 2012, was \$36.5 million, which primarily consisted of proceeds from the sale of our Term Preferred Stock and proceeds from the issuance of mortgage notes payable, partially offset by distributions paid to our stockholders, principal repayments on mortgage notes payable and net repayments on our Line of Credit. Net cash provided by financing activities for the six months ended June 30, 2011, was \$2.1 million, which primarily consisted of proceeds from the sale of common stock, partially offset by distributions paid to our stockholders, principal repayments on mortgage notes payable and net repayments on our Line of Credit.



**Table of Contents***Line of Credit*

In December 2010, we procured a \$50.0 million Line of Credit maturing on December 28, 2013, with Capital One, N.A. serving as a revolving lender, a letter of credit issuer and as an administrative agent and Branch Banking and Trust Company serving as a revolving lender and letter of credit issuer. The Line of Credit originally provided for a senior secured revolving credit facility of up to \$50.0 million, with a standby letter of credit sublimit of up to \$20.0 million. In January 2012, the Line of Credit was expanded to \$75.0 million and Citizens Bank of Pennsylvania was added as a revolving lender and letter of credit issuer. Currently, seven of our properties are pledged as collateral under our Line of Credit. The interest rate per annum applicable to the Line of Credit is equal to the London Interbank Offered Rate, or LIBOR, plus an applicable margin of up to 3.00% depending upon our leverage. Our leverage ratio used in determining the applicable margin for interest on the Line of Credit is recalculated quarterly. We are subject to an annual maintenance fee of 0.25% per year. Our ability to access this source of financing is subject to our continued ability to meet customary lending requirements such as compliance with financial and operating covenants and our meeting certain lending limits. One such covenant requires us to limit distributions to our stockholders to 95% of our FFO, with acquisition-related costs required to be expensed under ASC 805 added back to FFO for covenant purposes. In addition, the maximum amount that we may draw under this agreement is based on a percentage of the value of properties pledged as collateral to the banks, which must meet agreed upon eligibility standards.

When we are able to procure mortgages for these pledged properties, the banks will release the properties from the Line of Credit and reduce the availability under the Line of Credit by the advanced amount of the released property. Conversely, as we purchase new properties meeting the eligibility standards, we may pledge these new properties to obtain additional advances under the Line of Credit. Our availability under the Line of Credit will also be reduced by letters of credit used in the ordinary course of business. We may use the advances under the Line of Credit for both general corporate purposes and the acquisition of new investments.

At June 30, 2012, there was \$0 outstanding under the Line of Credit and \$6.1 million outstanding under letters of credit at a weighted average interest rate of 2.8%. At June 30, 2012, the remaining borrowing capacity available under the Line of Credit was \$22.1 million. Our ability to increase the availability under our Line of Credit is dependent upon our pledging additional properties as collateral. Traditionally, we have pledged new properties to the Line of Credit as we arrange for long-term mortgages for these pledged properties. Currently, only 9 of our properties do not have long-term mortgages, and 7 of those are pledged as collateral under our Line of Credit. Accordingly, we have only 2 properties which are unencumbered. We were in compliance with all covenants under the Line of Credit as of June 30, 2012.

**Contractual Obligations**

The following table reflects our material contractual obligations as of June 30, 2012:

Contractual Obligations	Total	Payments Due by Period (Dollars in Thousands)			
		Less than 1 Year	1-3 Years	3-5 Years	More than 5 Years
Debt Obligations <sup>(1)</sup>	\$ 354,077	\$ 5,006	\$ 81,137 <sup>(4)</sup>	\$ 199,652	\$ 68,286
Interest on Debt Obligations <sup>(2)</sup>	90,984	19,380	34,671	22,339	14,594
Operating Lease Obligations <sup>(3)</sup>	7,608	413	825	825	5,545
Total	\$ 452,669	\$ 24,799	\$ 116,633	\$ 222,816	\$ 88,425

(1) Debt obligations represent borrowings under our Line of Credit, which represents \$0 of the debt obligation due in 2013, mortgage notes payable that were outstanding as of June 30, 2012 and amounts due under our Term Preferred Stock.

(2) Interest on debt obligations includes estimated interest on our borrowings under our Line of Credit, mortgage notes payable and interest due under our Term Preferred Stock. The balance and interest rate on our Line of Credit is variable; thus, the amount of interest calculated for purposes of this table was based upon rates and balances as of June 30, 2012.

## Edgar Filing: GLADSTONE COMMERCIAL CORP - Form 10-Q

- (3) Operating lease obligations represent the ground lease payments due on our Tulsa, Oklahoma, Dartmouth, Massachusetts, and Springfield, Missouri properties.
  
- (4) The \$45.2 million mortgage note issued in September 2008 was extended to September 30, 2012. We have an additional option to extend the maturity date until October 2013.

## **Table of Contents**

### **Off-Balance Sheet Arrangements**

We did not have any off-balance sheet arrangements as of June 30, 2012.

### **Funds from Operations**

The National Association of Real Estate Investment Trusts, or NAREIT, developed FFO as a relative non-GAAP supplemental measure of operating performance of an equity REIT, in order to recognize that income-producing real estate historically has not depreciated on the same basis determined under GAAP. FFO, as defined by NAREIT, is net income (computed in accordance with GAAP), excluding gains or losses from sales of property and impairment losses on property, plus depreciation and amortization of real estate assets, and after adjustments for unconsolidated partnerships and joint ventures.

FFO does not represent cash flows from operating activities in accordance with GAAP, which, unlike FFO, generally reflects all cash effects of transactions and other events in the determination of net income and should not be considered an alternative to net income as an indication of our performance or to cash flows from operations as a measure of liquidity or ability to make distributions. Comparison of FFO, using the NAREIT definition, to similarly titled measures for other REITs may not necessarily be meaningful due to possible differences in the application of the NAREIT definition used by such REITs.

FFO available to common stockholders is FFO adjusted to subtract distributions made to holders of preferred and senior common stock. We believe that net income available to common stockholders is the most directly comparable GAAP measure to FFO available to common stockholders.

Basic funds from operations per share, or Basic FFO per share, and diluted funds from operations per share, or Diluted FFO per share, is FFO available to common stockholders divided by the number of weighted average shares of common stock outstanding and FFO available to common stockholders divided by the number of weighted average shares of common stock outstanding on a diluted basis, respectively, during a period. We believe that FFO available to common stockholders, Basic FFO per share and Diluted FFO per share are useful to investors because they provide investors with a further context for evaluating our FFO results in the same manner that investors use net income and earnings per share, or EPS, in evaluating net income available to common stockholders. In addition, because most REITs provide FFO available to common stockholders, Basic FFO and Diluted FFO per share information to the investment community, we believe these are useful supplemental measures when comparing us to other REITs. We believe that net income is the most directly comparable GAAP measure to FFO, Basic EPS is the most directly comparable GAAP measure to Basic FFO per share, and that diluted EPS is the most directly comparable GAAP measure to Diluted FFO per share.

The following table provides a reconciliation of our FFO for the three and six months ended June 30, 2012 and 2011, to the most directly comparable GAAP measure, net income, and a computation of basic and diluted FFO per weighted average share of common stock and basic and diluted net income per weighted average share of common stock:

**Table of Contents**

	For the three months ended June 30,	
	2012	2011
	(Dollars in Thousands, Except Per Share Data)	
Net income	\$ 854	\$ 1,370
Less: Distributions attributable to preferred and senior common stock	(1,046)	(1,039)
Net (loss) income available to common stockholders	(192)	331
Add: Real estate depreciation and amortization	3,992	3,475
FFO available to common stockholders	\$ 3,800	\$ 3,806
Weighted average shares outstanding basic	10,945	9,782
Weighted average shares outstanding diluted	10,945	9,834
Basic & diluted net (loss) income per weighted average share of common stock	\$ (0.02)	\$ 0.04
Basic FFO per weighted average share of common stock	\$ 0.35	\$ 0.39
Diluted FFO per weighted average share of common stock	\$ 0.35	\$ 0.39
Distributions declared per share of common stock	\$ 0.375	\$ 0.375

	For the six months ended June 30,	
	2012	2011
	(Dollars in Thousands, Except Per Share Data)	
Net income	\$ 2,155	\$ 2,850
Less: Distributions attributable to preferred and senior common stock	(2,088)	(2,078)
Net income available to common stockholders	67	772
Add: Real estate depreciation and amortization	7,896	6,845
FFO available to common stockholders	\$ 7,963	\$ 7,617
Weighted average shares outstanding basic	10,945	9,522
Weighted average shares outstanding diluted	11,011	9,573
Basic & diluted net (loss) income per weighted average share of common stock	\$ 0.01	\$ 0.08
Basic FFO per weighted average share of common stock	\$ 0.73	\$ 0.80
Diluted FFO per weighted average share of common stock	\$ 0.73	\$ 0.80
Distributions declared per share of common stock	\$ 0.750	\$ 0.750

## **Table of Contents**

### **Item 3. Quantitative and Qualitative Disclosures About Market Risk.**

Market risk includes risks that arise from changes in interest rates, foreign currency exchange rates, commodity prices, equity prices and other market changes that affect market sensitive instruments. The primary risk that we believe we are and will be exposed to is interest rate risk. 4 of our 62 leases contain escalations based on market indices, and the interest rate on our existing Line of Credit is variable. Although we seek to mitigate this risk by structuring such provisions of our loans and leases to contain a minimum interest rate or escalation rate, as applicable, these features do not eliminate this risk. We have not entered into any derivative contracts to attempt to further manage our exposure to interest rate fluctuations.

To illustrate the potential impact of changes in interest rates on our net income for the three and six months ended June 30, 2012, we have performed the following analysis, which assumes that our balance sheet remains constant and that no further actions beyond a minimum interest rate or escalation rate are taken to alter our existing interest rate sensitivity.

We analyzed the impact of a 1%, 2% and 3% increase in the one month LIBOR for the three and six months ended June 30, 2012. Due to the fact that our Line of Credit balance was \$0 as of June 30, 2012, there was no impact to interest expense from the stress testing. In addition, there was no impact on rental income because a hypothetical 3% increase in LIBOR is below the interest rate floor present in our LIBOR lease, thus there was no impact from the stress testing. As of June 30, 2012, our effective average LIBOR was 0.25%; thus, a 1%, 2% or 3% decrease could not occur.

As of June 30, 2012, the fair value of our fixed rate mortgage debt outstanding was \$326.5 million. Interest rate fluctuations may affect the fair value of our fixed rate debt instruments. If interest rates on our fixed rate debt instruments, using rates at June 30, 2012, had been one percentage point higher or lower, the fair value of those debt instruments on that date would have decreased or increased by \$11.0 million and \$12.5 million, respectively.

In the future, we may be exposed to additional effects of interest rate changes, primarily as a result of our Line of Credit or long-term mortgage debt, which we use to maintain liquidity and fund expansion of our real estate investment portfolio and operations. Our interest rate risk management objectives are to limit the impact of interest rate changes on earnings and cash flows and to lower overall borrowing costs. To achieve these objectives, we will borrow primarily at fixed rates or variable rates with the lowest margins available and, in some cases, with the ability to convert variable rates to fixed rates. We may also enter into derivative financial instruments such as interest rate swaps and caps in order to mitigate the interest rate risk on a related financial instrument. We will not enter into derivative or interest rate transactions for speculative purposes.

In addition to changes in interest rates, the value of our real estate is subject to fluctuations based on changes in local and regional economic conditions and changes in the creditworthiness of lessees and borrowers, all of which may affect our ability to refinance debt, if necessary.

**Table of Contents**

**Item 4. Controls and Procedures.**

a) Evaluation of Disclosure Controls and Procedures

As of June 30, 2012, our management, including our chief executive officer and chief financial officer and treasurer, evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)). Based on that evaluation, management, including the chief executive officer and chief financial officer, concluded that our disclosure controls and procedures were effective as of June 30, 2012, in providing a reasonable level of assurance that information we are required to disclose in reports that we file or submit under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in applicable SEC rules and forms, including providing a reasonable level of assurance that information required to be disclosed by us in such reports is accumulated and communicated to our management, including our chief executive officer and our chief financial officer, as appropriate to allow timely decisions regarding required disclosure. However, in evaluating the disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated can provide only reasonable assurance of necessarily achieving the desired control objectives, and management was required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

b) Changes in Internal Control over Financial Reporting

There were no changes in our internal control over financial reporting that occurred during the quarter ended June 30, 2012, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**Table of Contents**

**PART II OTHER INFORMATION**

**Item 1. Legal Proceedings**

Neither we nor any of our subsidiaries are currently subject to any material legal proceedings, nor, to our knowledge, is any material legal proceeding threatened against us or our subsidiaries.

**Item 1A. Risk Factors**

Our business is subject to certain risks and events that, if they occur, could adversely affect our financial condition and results of operations and the trading price of our securities. For a discussion of these risks, please refer to the section captioned **Item 1A. Risk Factors** in our Annual Report on Form 10-K for the year ended December 31, 2011, filed by us with the Securities and Exchange Commission on February 28, 2012.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

Not applicable.

**Item 3. Defaults Upon Senior Securities**

Not applicable.

**Item 4. Mine Safety Disclosures**

Not applicable.

**Item 5. Other Information**

Not applicable.

**Table of Contents**

**Item 6. Exhibits**

**Exhibit Index**

<b>Exhibit Number</b>	<b>Exhibit Description</b>
3.1	Articles of Restatement, incorporated by reference to Exhibit 3.1 to the Form 10-Q (File No. 001-33097), filed April 30, 2012.
3.2	Bylaws of the Registrant, incorporated by reference to Exhibit 3.2 to the Registration Statement on Form S-11 (File No. 333-106024), filed June 11, 2003.
3.2.1	First Amendment to Bylaws of the Registrant, incorporated by reference to Exhibit 99.1 of the Registrant's Current Report on Form 8-K, (File No. 001-33097) filed July 10, 2007.
4.1	Form of Certificate for Common Stock of the Registrant, incorporated by reference to Exhibit 4.1 to the Registrant's Registration Statement on Form S-11 (File No. 333-106024), filed August 8, 2003.
4.2	Form of Certificate for 7.75% Series A Cumulative Redeemable Preferred Stock of the Registrant, incorporated by reference to Exhibit 4.1 of the Registrant's Form 8-A12G (File No. 000-50363), filed January 19, 2006.
4.3	Form of Certificate for 7.50% Series B Cumulative Redeemable Preferred Stock of the Registrant, incorporated by reference to Exhibit 4.2 of the Registrant's Form 8-A12B (File No. 001-33097), filed October 19, 2006.
4.4	Form of Certificate for 7.125% Series C Cumulative Term Preferred Stock of Gladstone Commercial Corporation, incorporated by reference to Exhibit 4.4 of the Registrant's Current Report on Form 8-A12B (File No. 001-33097), filed January 31, 2012.
11	Computation of Per Share Earnings from Operations (included in the notes to the unaudited financial statements contained in this Report).
12	Statements re: computation of ratios (filed herewith).
31.1	Certification of Chief Executive Officer pursuant to Section 302 of The Sarbanes-Oxley Act of 2002 (filed herewith).
31.2	Certification of Chief Financial Officer pursuant to Section 302 of The Sarbanes-Oxley Act of 2002 (filed herewith).
32.1	Certification of Chief Executive Officer pursuant to Section 906 of The Sarbanes-Oxley Act of 2002 (furnished herewith).
32.2	Certification of Chief Financial Officer pursuant to Section 906 of The Sarbanes-Oxley Act of 2002 (furnished herewith).
101.INS***	XBRL Instance Document
101.SCH***	XBRL Taxonomy Extension Schema Document
101.CAL***	XBRL Taxonomy Extension Calculation Linkbase Document



**Table of Contents**

101.LAB***	XBRL Taxonomy Extension Label Linkbase Document
101.PRE***	XBRL Taxonomy Extension Presentation Linkbase Document

\*\*\* The following financial information of the Registrant is included for the three months ended June 30, 2012, formatted in XBRL (eXtensible Business Reporting Language): (i) Condensed Consolidated Balance Sheets (Unaudited), (ii) Condensed Consolidated Statements of Operations (Unaudited), (iii) Condensed Consolidated Statements of Cash Flows (Unaudited) and (iv) Notes to Condensed Consolidated Financial Statements (Unaudited).

Pursuant to Rule 406T of Regulation S-T, the Interactive Data Files on Exhibit 101 hereto are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, are deemed not filed for purposes of Section 18 of the Securities and Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.

**Table of Contents**

**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

**Gladstone Commercial Corporation**

Date: July 31, 2012

By: /s/ Danielle Jones  
Danielle Jones  
Chief Financial Officer and Treasurer

Date: July 31, 2012

By: /s/ David Gladstone  
David Gladstone  
Chief Executive Officer and  
  
Chairman of the Board of Directors