

GLADSTONE COMMERCIAL CORP

Form 10-Q

May 04, 2015

Table of Contents

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**WASHINGTON, D.C. 20549**

**FORM 10-Q**

(Mark One)

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

**FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2015**

**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)**

**MARYLAND**  
**(State or other jurisdiction of**  
**incorporation or organization)**  
**1521 WESTBRANCH DRIVE, SUITE 100**

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

**MCLEAN, VIRGINIA**  
**(Address of principal executive offices)**  
**(703) 287-5800**

**22102**  
**(Zip Code)**

**(Registrant's telephone number, including area code)**

**Not Applicable**

**(Former name, former address and formal fiscal year, if changed since last report)**

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 May 4, 2015 was 20,731,094.



Table of Contents

**GLADSTONE COMMERCIAL CORPORATION**

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

**MARCH 31, 2015**

**TABLE OF CONTENTS**

|   | PAGE |
|---|------|
| <b>PART I FINANCIAL INFORMATION</b>   |      |
| Item 1. <u>Financial Statements (Unaudited)</u>   |      |
| <u>Condensed Consolidated Balance Sheets as of March 31, 2015 and December 31, 2014</u>                   | 3    |
| <u>Condensed Consolidated Statements of Operations for the three months ended March 31, 2015 and 2014</u> | 4    |
| <u>Condensed Consolidated Statements of Cash Flows for the three months ended March 31, 2015 and 2014</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>      | 26   |
| Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>                                 | 42   |
| Item 4. <u>Controls and Procedures</u>  | 43   |
| <b>PART II OTHER INFORMATION</b>  |      |
| Item 1. <u>Legal Proceedings</u>  | 44   |
| Item 1A. <u>Risk Factors</u>  | 44   |
| Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>                                | 44   |
| Item 3. <u>Defaults Upon Senior Securities</u>  | 44   |
| Item 4. <u>Mine Safety Disclosures</u>  | 44   |
| Item 5. <u>Other Information</u>  | 44   |
| Item 6. <u>Exhibits</u>   | 44   |
| <u>SIGNATURES</u>   | 47   |

**Table of Contents****PART I FINANCIAL INFORMATION****Item 1. Financial Statements****Gladstone Commercial Corporation****Condensed Consolidated Balance Sheets****(Dollars in Thousands, Except Share and Per Share Data)****(Unaudited)**

|   | March 31, 2015    | December 31, 2014 |
|---|-------------------|-------------------|
| <b>ASSETS</b>   |                   |                   |
| Real estate, at cost  | \$ 740,842        | \$ 722,565        |
| Less: accumulated depreciation  | 96,760            | 92,133            |
| Total real estate, net  | 644,082           | 630,432           |
| Lease intangibles, net  | 102,808           | 98,814            |
| Real estate and related assets held for sale, net   | 2,980             |                   |
| Mortgage note receivable  | 5,600             | 5,600             |
| Cash and cash equivalents   | 5,760             | 8,599             |
| Restricted cash   | 3,860             | 3,547             |
| Funds held in escrow  | 11,091            | 11,096            |
| Deferred rent receivable, net   | 23,447            | 21,728            |
| Deferred financing costs, net   | 5,990             | 6,213             |
| Other assets  | 1,664             | 1,765             |
| <b>TOTAL ASSETS</b>   | <b>\$ 807,282</b> | <b>\$ 787,794</b> |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY</b>  |                   |                   |
| <b>LIABILITIES</b>  |                   |                   |
| Mortgage notes payable  | \$ 469,048        | \$ 459,299        |
| Borrowings under line of credit   | 41,300            | 43,300            |
| Series C mandatorily redeemable preferred stock, par value \$0.001 per share; \$25 per share liquidation preference; 1,700,000 shares authorized; and 1,540,000 shares issued and outstanding at March 31, 2015 and December 31, 2014, respectively | 38,500            | 38,500            |
| Deferred rent liability, net  | 8,374             | 8,594             |
| Asset retirement obligation   | 3,675             | 3,616             |
| Accounts payable and accrued expenses   | 7,362             | 8,285             |
| Other liabilities related to assets held for sale   | 2,587             |                   |
| Due to Adviser and Administrator <sup>(1)</sup>   | 1,721             | 916               |
| Other liabilities   | 7,558             | 7,612             |
| Total Liabilities   | \$ 580,125        | \$ 570,122        |

Commitments and contingencies <sup>(2)</sup>

## STOCKHOLDERS EQUITY

|  |           |                |           |                |
|--|-----------|----------------|-----------|----------------|
| 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 March 31, 2015 and December 31, 2014, respectively | \$        | 2              | \$        | 2              |
| Senior common stock, par value \$0.001 per share; 7,500,000 shares authorized and 1,001,957 and 809,411 shares issued and outstanding at March 31, 2015 and December 31, 2014, respectively  |           | 1              |           | 1              |
| Common stock, par value \$0.001 per share, 38,500,000 shares authorized and 20,459,687 and 19,589,606 shares issued and outstanding at March 31, 2015 and December 31, 2014, respectively  |           | 20             |           | 20             |
| Additional paid in capital   |           | 387,392        |           | 369,748        |
| Notes receivable - employee  |           | (375)          |           | (375)          |
| Distributions in excess of accumulated earnings  |           | (159,883)      |           | (151,724)      |
| <b>Total Stockholders Equity</b>   |           | <b>227,157</b> |           | <b>217,672</b> |
| <b>TOTAL LIABILITIES AND STOCKHOLDERS EQUITY</b>   | <b>\$</b> | <b>807,282</b> | <b>\$</b> | <b>787,794</b> |

(1) Refer to Note 2 Related-Party Transactions

(2) Refer to Note 9 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 March 31, |                 |
|---|--------------------------------------|-----------------|
|   | 2015                                 | 2014            |
| Operating revenues  |                                      |                 |
| Rental revenue  | \$ 19,288                            | \$ 16,585       |
| Tenant recovery revenue   | 324                                  | 551             |
| Interest income from mortgage note receivable                                 | 268                                  |                 |
| <b>Total operating revenues</b>   | <b>19,880</b>                        | <b>17,136</b>   |
| Operating expenses  |                                      |                 |
| Depreciation and amortization   | 8,207                                | 6,720           |
| Property operating expenses   | 962                                  | 1,330           |
| Acquisition related expenses  | 196                                  | 110             |
| Base management fee <sup>(1)</sup>  | 852                                  | 625             |
| Incentive fee <sup>(1)</sup>  | 1,673                                | 1,240           |
| Administration fee <sup>(1)</sup>   | 362                                  | 492             |
| General and administrative  | 690                                  | 466             |
| Impairment charge   |                                      | 13,958          |
| <b>Total operating expenses before credit to incentive fee</b>                | <b>12,942</b>                        | <b>24,941</b>   |
| Credit to incentive fee <sup>(1)</sup>  | (1,185)                              | (1,205)         |
| <b>Total operating expenses</b>   | <b>11,757</b>                        | <b>23,736</b>   |
| Other income (expense)  |                                      |                 |
| Interest expense  | (6,771)                              | (6,275)         |
| Distributions attributable to Series C mandatorily redeemable preferred stock | (686)                                | (686)           |
| Other income  | 28                                   | 47              |
| <b>Total other expense</b>  | <b>(7,429)</b>                       | <b>(6,914)</b>  |
| <b>Net income (loss)</b>  | <b>694</b>                           | <b>(13,514)</b> |
| Distributions attributable to Series A and B preferred stock                  | (1,023)                              | (1,023)         |
| Distributions attributable to senior common stock                             | (224)                                | (100)           |

Edgar Filing: GLADSTONE COMMERCIAL CORP - Form 10-Q

|  |    |            |    |            |
|--|----|------------|----|------------|
| Net loss attributable to common stockholders                               | \$ | (553)      | \$ | (14,637)   |
| <b>Loss per weighted average share of common stock basic &amp; diluted</b> |    |            |    |            |
| Loss attributable to common shareholders                                   | \$ | (0.03)     | \$ | (0.93)     |
| <b>Weighted average shares of common stock outstanding</b>                 |    |            |    |            |
| Basic and Diluted  |    | 20,210,975 |    | 15,746,714 |
| <b>Earnings per weighted average share of senior common stock</b>          |    |            |    |            |
|  | \$ | 0.26       | \$ | 0.26       |
| Weighted average shares of senior common stock outstanding basic           |    | 866,201    |    | 385,875    |

(1) 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 three months ended March 31, |                |
|--|--------------------------------------|----------------|
|  | 2015                                 | 2014           |
| <b>Cash flows from operating activities:</b>   |                                      |                |
| Net income (loss)  | \$ 694                               | \$ (13,514)    |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: |                                      |                |
| Depreciation and amortization  | 8,207                                | 6,720          |
| Impairment charge  |                                      | 13,958         |
| Amortization of deferred financing costs   | 431                                  | 386            |
| Amortization of deferred rent asset and liability, net                                   | (141)                                | (92)           |
| Amortization of discount and premium on assumed debt                                     | (77)                                 | (44)           |
| Asset retirement obligation expense  | 38                                   | (180)          |
| (Increase) decrease in other assets  | (2)                                  | 298            |
| Increase in deferred rent receivable   | (856)                                | (906)          |
| Increase (decrease) in accounts payable, accrued expenses, and amount due                |                                      |                |
| Adviser and Administrator  | 1,008                                | (372)          |
| Decrease in other liabilities  | (301)                                | (41)           |
| Leasing commissions paid   | (65)                                 | (54)           |
| <b>Net cash provided by operating activities</b>   | <b>8,936</b>                         | <b>6,159</b>   |
| <b>Cash flows from investing activities:</b>   |                                      |                |
| Acquisition of real estate and related intangible assets                                 | (28,348)                             | (3,718)        |
| Improvements of existing real estate   | (1,697)                              | (1,673)        |
| Receipts from lenders for funds held in escrow   | 68                                   | 496            |
| Payments to lenders for funds held in escrow   | (801)                                | (1,260)        |
| Receipts from tenants for reserves   | 795                                  | 790            |
| Payments to tenants from reserves  | (511)                                | (2,335)        |
| (Increase) decrease in restricted cash   | (314)                                | 1,545          |
| Deposits on future acquisitions  | (150)                                | (250)          |
| Deposits applied against real estate investments   | 250                                  | 127            |
| <b>Net cash used in investing activities</b>   | <b>(30,708)</b>                      | <b>(6,278)</b> |
| <b>Cash flows from financing activities:</b>   |                                      |                |
| Proceeds from issuance of equity   | 18,135                               | 7,707          |
| Offering costs   | (542)                                | (503)          |
| Borrowings under mortgage notes payable  | 14,573                               |                |

Edgar Filing: GLADSTONE COMMERCIAL CORP - Form 10-Q

|  |          |          |
|--|----------|----------|
| Payments for deferred financing costs                                  | (216)    | (360)    |
| Principal repayments on mortgage notes payable                         | (2,245)  | (2,172)  |
| Borrowings from line of credit   | 22,000   | 12,700   |
| Repayments on line of credit   | (24,000) | (13,000) |
| Increase in security deposits  | 30       |          |
| Distributions paid for common, senior common and preferred stock       | (8,802)  | (6,986)  |
| Net cash provided by (used in) financing activities                    | 18,933   | (2,614)  |
| Net decrease in cash and cash equivalents                              | (2,839)  | (2,733)  |
| Cash and cash equivalents, beginning of period                         | 8,599    | 8,546    |
| Cash and cash equivalents, end of period                               | \$ 5,760 | \$ 5,813 |
| <b>NON-CASH INVESTING AND FINANCING INFORMATION</b>                    |          |          |
| Increase in asset retirement obligation                                | \$ 21    | \$       |
| Fixed rate principal debt assumed in connection with acquisition       | \$       | \$ 6,330 |
| Senior common dividend issued in the dividend reinvestment program     | \$ 51    | \$ 39    |
| Capital improvements included in accounts payable and accrued expenses | \$ 4,402 | \$ 671   |

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)**

**1. Organization, Basis of Presentation and Significant Accounting Policies**

Gladstone Commercial Corporation is a real estate investment trust, or 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, or the Adviser, and administrative services are provided by Gladstone Administration, LLC, a Delaware limited liability company, or the Administrator, each pursuant to a contractual arrangement with us. Our Adviser and Administrator collectively employ all of our personnel and pay their salaries, benefits, and general expenses directly.

All further references herein to we, our, us and the Company mean Gladstone Commercial Corporation and its consolidated subsidiaries, except where it is made clear that the term means only Gladstone Commercial Corporation. All references to the number of properties and square footage are unaudited.

*Subsidiaries*

Gladstone Commercial Corporation conducts substantially all of its operations through a subsidiary, Gladstone Commercial Limited Partnership, a Delaware limited partnership, or the Operating Partnership. As Gladstone Commercial Corporation currently owns all of the general and limited partnership interests of the Operating Partnership through two of its subsidiaries, GCLP Business Trust I and II, the financial position and results of operations of the Operating Partnership are consolidated within Gladstone Commercial Corporation's financial statements.

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

Gladstone Commercial Lending, LLC, a Delaware limited liability company, or Gladstone Commercial Lending, a subsidiary of Gladstone Commercial Corporation, was created to conduct all operations related to Gladstone Commercial Corporation's real estate mortgage loans. 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 Gladstone Commercial Corporation.

Gladstone Commercial Advisers, Inc., a Delaware corporation, or Commercial Advisers, and a wholly-owned subsidiary of Gladstone Commercial Corporation, is a taxable REIT subsidiary, or TRS, which was created to collect any non-qualifying income related to our real estate portfolio. There has been no such income earned to date. Since Gladstone Commercial Corporation owns 100% of the voting securities of Commercial Advisers, the financial position and results of operations of Commercial Advisers are consolidated within Gladstone Commercial Corporation's financial statements.



## **Table of Contents**

### *Interim Financial Information*

Our interim financial statements are prepared in accordance with U.S. generally accepted accounting principles, or 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. The year-end balance sheet data presented herein was derived from audited financial statements, but does not include all disclosures required by GAAP. In the opinion of our management, all adjustments, consisting solely of normal recurring accruals, necessary for the fair presentation 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, 2014, as filed with the U.S. Securities and Exchange Commission on February 18, 2015. The results of operations for the three months ended March 31, 2015 are not necessarily indicative of the results that may be expected for other interim periods or for the full fiscal year.

### *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.

### *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 20 years for equipment and fixtures, and the shorter of the useful life or the remaining lease term for tenant improvements and leasehold interests.

Certain of our acquisitions involve sale-leaseback transactions with newly-originated leases, which we account for as asset acquisitions under Accounting Standards Codification, or ASC, 805, Business Combinations. In the case of an asset acquisition, we will capitalize the transaction costs incurred in connection with the acquisition. Other of our acquisitions involve the acquisition of properties that are already being operated as rental properties, which we will generally consider to be a business combination under ASC 805. Business combination guidance is generally applicable to us when properties are acquired with leases in place at the time of acquisition. When an acquisition is considered a business combination, ASC 805 requires that the purchase price of real estate be allocated to the acquired tangible assets and liabilities, consisting of land, building, tenant improvements, long-term debt assumed and identified intangible assets and liabilities, typically the value of above-market and below-market leases, the value of in-place leases, the value of unamortized lease origination costs and the value of tenant relationships, based in each case on their fair values. ASC 805 also requires that all expenses related to an acquisition accounted for as a business combination to 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 acquired and liabilities assumed. In estimating carrying costs, management also includes lost reimbursement of real estate taxes,

insurance and other operating expenses as well as 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.

## **Table of Contents**

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 on the date of acquisition. Real estate depreciation expense on these tangible assets was \$5.2 million and \$4.4 million for the three months ended March 31, 2015 and 2014, respectively.

Above-market and below-market in-place lease fair 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) 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 which fixed-rate renewal options, if any, should be included. The capitalized above-market lease values, included in the accompanying condensed consolidated balance sheets 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, for both the three months ended March 31, 2015 and 2014, 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, including any below market renewal periods. Total amortization related to below-market lease values was \$0.2 million, for both the three months ended March 31, 2015 and 2014, 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 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. Total amortization expense related to these intangible assets and liabilities was \$3.0 million and \$2.3 million for the three months ended March 31, 2015 and 2014, respectively.

Should a tenant terminate its lease, the unamortized portion of the above-market and below-market lease values would be charged to rental income and the unamortized portion of in-place lease values, lease origination costs and customer relationship intangibles would be immediately charged to amortization expense.

### *Real Estate Held for Sale and Discontinued Operations*

ASC 360-10, Property, Plant, and Equipment, requires that any properties which are held for sale, be presented separately in the condensed consolidated balance sheet. Real estate assets held for sale are measured at the lower of the carrying amount or the fair value, less the cost to sell, and are listed separately on our condensed consolidated balance sheet. Once properties are classified as held for sale, no further depreciation is recorded.

Under Accounting Standards Update No. 2014-08, Presentation of Financial Statements (Topic 205) and Property, Plant, and Equipment (Topic 360): Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity, only disposals representing a strategic shift in operations, such as a disposal of a major geographic area, a major line of business, or a major equity method investment, will be presented as discontinued operations. We evaluated our held for sale assets according to this criteria, and determined we were not required to present our assets classified as held for sale during the quarter ended March 31, 2015 as discontinued operations.



## **Table of Contents**

### *Impairment Charges*

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 whether impairment of the carrying value of the investment exists or that depreciation periods should be modified. If circumstances indicate 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 value of the investment in such property is recoverable. In performing the analysis, we consider such factors as each tenant's payment history and financial condition, the likelihood of lease renewal, business conditions in the industry in which the tenants operate, whether there are indications that the fair value of the real estate has decreased and our intended holding period of the property. If the carrying amount is more than the aggregate undiscounted future cash flows, we would recognize an impairment loss to the extent the carrying amount exceeds the estimated fair value of the property.

We evaluate our entire portfolio of properties each quarter for any impairment indicators and perform an impairment analysis on those select properties that have an indication of impairment. We performed this evaluation and analysis and concluded that none of our properties were impaired as of March 31, 2015; however, we determined that our property located in Dayton, Ohio is at risk to become impaired in the future. The lease with the tenant in this property terminates on June 30, 2015. There is a possibility we may have to impair this property during 2015 if we do not find a replacement tenant.

### *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 \$0.2 million and \$0.4 million for deferred financing costs during the three months ended March 31, 2015 and 2014, respectively. Total amortization expense related to deferred financing costs is included in interest expense and was \$0.4 million, for both the three months ended March 31, 2015 and 2014, 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 or 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 were recorded during the three months ended March 31, 2015, and 2014, respectively.

Tenant recovery revenue includes payments from tenants as reimbursements for franchise taxes, management fees, insurance, maintenance and repairs, utilities, and ground lease payments. We recognize tenant recovery revenue in the

same periods that we incur the related expenses.

---

**Table of Contents***Mortgage Note Receivable*

Management considers its loans and other lending investments to be held-for-investment. We reflect our loans classified as long-term investments at amortized cost, less allowance for loan losses, acquisition premiums or discounts, and deferred loan fees. On occasion, we may acquire loans at small premiums or discounts based on the credit characteristics of such loans. These premiums or discounts would be recognized as yield adjustments over the lives of the related loans. Loan origination fees, as well as direct loan origination costs, are also deferred and recognized over the lives of the related loans as yield adjustments. If loans with premiums, discounts, or loan origination fees are prepaid, we would immediately recognize the unamortized portion as a decrease or increase in the prepayment gain or loss. Interest income is recognized using the effective interest method applied on a loan-by-loan basis. Prepayment penalties or yield maintenance payments from borrowers are recognized as additional income when received.

*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. We have accrued a liability at the present value of the estimated payments expected to be made 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 to their estimated obligation over the life of the leases for the respective properties. We accrued approximately \$20,000 in liabilities in connection with acquisitions during the three months ended March 31, 2015. There were no liabilities accrued during the three months ended March 31, 2014. We recorded expense of \$0.04 million and \$0.03 million during the three months ended March 31, 2015 and 2014 respectively, to general and administrative expense. Costs of future expenditures for obligations are discounted to their present value. The aggregate undiscounted obligation on all properties is \$9.4 million and the discount rates used in the calculations range from 2.5% to 7.6%. We do not expect to make any payments in conjunction with these obligations in each of the next five years.

*Comprehensive Income (Loss)*

For the three months ended March 31, 2015 and 2014, comprehensive income (loss) equaled net income (loss); therefore, a separate statement of comprehensive income (loss) is not included in the accompanying condensed consolidated financial statements.

*Segment Reporting*

We manage our operations on an aggregated, single segment basis for purposes of assessing performance and making operating decisions, and, accordingly, have only one reporting and operating segment.

*Recently Issued Accounting Pronouncements*

In May 2014, the FASB issued ASU 2014-09, *Revenue from Contracts with Customers*, which supersedes or replaces nearly all GAAP revenue recognition guidance. The new guidance establishes a new control-based revenue recognition model, changes the basis for deciding when revenue is recognized over time or at a point in time and will

expand disclosures about revenue. We are currently assessing the impact of ASU 2014-09. ASU 2014-09 is effective for annual reporting periods that begin after December 15, 2016 and interim periods within those years. Early adoption is not permitted.

In February 2015, the FASB issued ASU 2015-02, Amendments to the Consolidation Analysis ( ASU-2015-02 ), which amends or supersedes the scope and consolidation guidance under existing GAAP. The new standard changes the way a reporting entity evaluates whether a) limited partnerships and similar entities should be consolidated, b) fees paid to decision makers or service providers are variable interests in

---

**Table of Contents**

a variable interest entity, or VIE, and c) variable interests in a VIE held by related parties require the reporting entity to consolidate the VIE. ASU 2015-02 also eliminates the VIE consolidation model based on majority exposure to variability that applied to certain investment companies and similar entities. We are currently assessing the impact of ASU 2015-02, which is effective for annual and interim reporting periods beginning after December 15, 2015. Early adoption is permitted.

In April 2015, the FASB issued ASU 2015-03, *Simplifying the Presentation of Debt Issuance Costs* ( ASU-2015-03 ), which simplifies the presentation of debt issuance costs. We are currently assessing the impact of ASU 2015-03 and do not anticipate a material impact on our financial position, results of operations or cash flows from adopting this standard. ASU 2015-03 is effective for annual and interim reporting periods beginning after December 15, 2015. Early adoption is permitted.

**2. Related-Party Transactions****Gladstone Management and Gladstone Administration**

We are externally managed pursuant to contractual arrangements with our Adviser and our Administrator, which collectively employ all of our personnel and pay their salaries, benefits, and general expenses directly. Both our Adviser and Administrator are affiliates of ours, as their parent company is controlled by Mr. David Gladstone, our chairman and chief executive officer. We have an advisory agreement with our Adviser, or the Advisory Agreement, and an administration agreement with our Administrator, or the Administration Agreement. The management and administrative services and fees under the Advisory and Administration Agreements are described below. At March 31, 2015 and December 31, 2014, \$1.7 million and \$0.9 million, respectively, was collectively due to our 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 and adjusted to exclude the effect of any unrealized gains, losses or other items that do not affect realized net income (including impairment charges), or common stockholders' equity, and an incentive fee based on funds from operations, or FFO. For the three months ended March 31, 2015 and 2014, we recorded a base management fee of \$0.9 million, and \$0.6 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 (including impairment charges). The incentive fee rewards the Adviser if our quarterly FFO, before giving effect to any incentive fee, or pre-incentive fee FFO, exceeds 1.75%, or 7% annualized, or 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 months ended March 31, 2015, and 2014, we recorded an incentive fee of \$1.7 million, and \$1.2 million, respectively, offset by credits related to unconditional, voluntary and irrevocable waivers issued by the Adviser of \$1.2 million and \$1.2 million, respectively, resulting in a net incentive fee for the three months ended March 31, 2015, and 2014, of \$0.5 million, and \$40,000, 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 months ended March 31, 2015, and 2014, 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 expenses in performing services to us, including, but not limited to, rent and the salaries and benefits of its personnel, including our chief financial officer, treasurer, chief compliance officer, general counsel and secretary (who also serves as our Administrator's president), and their respective staffs. Prior to July 1, 2014,

## Table of Contents

our allocable portion was generally derived by multiplying that portion of the Administrator's expenses allocable to all funds managed by the Adviser by the percentage of our total assets at the beginning of each quarter in comparison to the total assets of all funds managed by the Adviser. As approved by our Board of Directors, effective July 1, 2014, our allocable portion of the Administrator's expenses is derived by multiplying our Administrator's total expenses by the approximate percentage of time the Administrator's employees perform services for us in relation to their time spent performing services for all companies serviced by our Administrator under contractual agreements. For the three months ended March 31, 2015, and 2014, we recorded an administration fee of \$0.4 million, and \$0.5 million, respectively.

## Gladstone Securities

Gladstone Securities, LLC, or Gladstone Securities, is a privately held broker dealer registered with the Financial Industry Regulatory Authority and insured by the Securities Investor Protection Corporation. Gladstone Securities is an affiliate of ours, as its parent company is controlled by Mr. David Gladstone, our chairman and chief executive officer. Mr. Gladstone also serves on the board of managers of Gladstone Securities.

## *Dealer Manager Agreement*

In connection with the offering of our Senior Common Stock (see Note 10, "Stockholders' Equity," for further details) we entered into a Dealer Manager Agreement, dated March 25, 2011, or the Dealer Manager Agreement, with Gladstone Securities pursuant to which Gladstone Securities agreed to act as our exclusive dealer manager in connection with the offering. Pursuant to the terms of the Dealer Manager Agreement, Gladstone Securities was 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. Gladstone Securities, in its sole and absolute discretion, was permitted to re-allocate all of its selling commissions attributable to a participating broker-dealer and 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 agreed to indemnify Gladstone Securities against various liabilities, including certain liabilities arising under the federal securities laws. We made approximately \$0.3 million, and \$40,000 of payments during the three months ended March 31, 2015, and 2014 respectively, to Gladstone Securities pursuant to this agreement, which are reflected as a component of Senior Common Stock costs in the condensed consolidated statement of stockholders' equity. The Dealer Manager Agreement terminated according to its terms on March 28, 2015, and we wrote-off \$0.1 million of deferred offering costs related to the termination of the agreement to general and administrative expense.

## *Mortgage Financing Arrangement Agreement*

We also entered into an agreement with Gladstone Securities, effective June 18, 2013, for it to act as our non-exclusive agent to assist us with arranging mortgage financing for properties we own. In connection with this engagement, Gladstone Securities may from time to time solicit the interest of various commercial real estate lenders or recommend to us third party lenders offering credit products or packages that are responsive to our needs. We pay Gladstone Securities a financing fee in connection with the services it provides to us for securing mortgage financing on any of our properties. The amount of these financing fees, which are payable upon closing of the financing, are based on a percentage of the amount of the mortgage, generally ranging from 0.15% to a maximum of 1.0% of the mortgage obtained. The amount of the financing fees may be reduced or eliminated, as determined by us and Gladstone Securities, after taking into consideration various factors, including, but not limited to, the involvement of any third party brokers and market conditions. We paid financing fees to Gladstone Securities of \$38,000 during the three months ended March 31, 2015, which are reflected as deferred financing costs in the condensed consolidated

balance sheets, on total mortgages secured of \$14.6 million, or 0.26%. We did not pay any financing fees to Gladstone Securities during the three months ended March 31, 2014. The agreement is scheduled to terminate on August 31, 2015, unless renewed or earlier terminated pursuant to the provisions contained therein.



**Table of Contents****3. Loss per Share of Common Stock**

The following tables set forth the computation of basic and diluted loss per share of common stock for each of the three months ended March 31, 2015 and 2014. We computed basic loss per share for the three months ended March 31, 2015 and 2014 using the weighted average number of shares outstanding during the periods. Diluted loss per share for the three months ended March 31, 2015 and 2014, reflects additional shares of common stock related to our convertible Senior Common Stock (if the effect would be dilutive), 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 (dollars in thousands, except per share amounts).

|  | For the three months ended March 31, |             |
|--|--------------------------------------|-------------|
|  | 2015                                 | 2014        |
| <b>Calculation of basic loss per share of common stock:</b>                    |                                      |             |
| Net loss attributable to common stockholders                                   | \$ (553)                             | \$ (14,637) |
| Denominator for basic weighted average shares of common stock                  | 20,210,975                           | 15,746,714  |
| Basic loss per share of common stock   | \$ (0.03)                            | \$ (0.93)   |
| <b>Calculation of diluted loss per share of common stock:</b>                  |                                      |             |
| Net loss attributable to common stockholders                                   | \$ (553)                             | \$ (14,637) |
| Add: Income impact of assumed conversion of senior common stock <sup>(1)</sup> |                                      |             |
| Net loss attributable to common stockholders plus assumed conversions          | \$ (553)                             | \$ (14,637) |
| Denominator for basic weighted average shares of common stock                  | 20,210,975                           | 15,746,714  |
| Effect of convertible senior common stock <sup>(1)</sup>                       |                                      |             |
| Denominator for diluted weighted average shares of common stock                | 20,210,975                           | 15,746,714  |
| Diluted loss per share of common stock   | \$ (0.03)                            | \$ (0.93)   |

<sup>(1)</sup> We excluded convertible senior common shares of 723,631 and 316,979, from the calculation of diluted earnings per share for the three months ended March 31, 2015 and 2014, respectively, because it was anti-dilutive.

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

Edgar Filing: GLADSTONE COMMERCIAL CORP - Form 10-Q

The following table sets forth the components of our investments in real estate as of March 31, 2015 and December 31, 2014 (dollars in thousands):

|                           | March 31, 2015 <sup>(1)</sup> | December 31, 2014 |
|---------------------------|-------------------------------|-------------------|
| Real estate:              |                               |                   |
| Land                      | \$ 91,343                     | \$ 88,394         |
| Building and improvements | 605,375                       | 593,155           |
| Tenant improvements       | 44,124                        | 41,016            |
| Accumulated depreciation  | (96,760)                      | (92,133)          |
| Real estate, net          | \$ 644,082                    | \$ 630,432        |

<sup>(1)</sup> Does not include real estate held for sale as of March 31, 2015.

**Table of Contents***2015 Real Estate Activity*

During the three months ended March 31, 2015, we acquired two properties, which are summarized below (dollars in thousands):

| Location                      | Acquisition Date | Square Footage (unaudited) | Lease Term | Renewal Options  | Total Purchase Price/Expenses Funded | Acquisition Expenses | Annualized Straight Line Rent | Total Debt Issued |
|-------------------------------|------------------|----------------------------|------------|------------------|--------------------------------------|----------------------|-------------------------------|-------------------|
| Richardson, TX <sup>(1)</sup> | 3/6/2015         | 155,984                    | 9.5 Years  | 2 (5 years each) | \$ 24,700                            | \$ 103               | \$ 2,708                      | \$ 14,573         |
| Birmingham, AL                | 3/20/2015        | 30,850                     | 8.5 Years  | 1 (5 years)      | 3,648                                | 66                   | 333                           | N/A               |
| <b>Total</b>                  |                  | <b>186,834</b>             |            |                  | <b>\$ 28,348</b>                     | <b>\$ 169</b>        | <b>\$ 3,041</b>               | <b>\$ 14,573</b>  |

<sup>(1)</sup> The tenant occupying this property is subject to a gross lease.

In accordance with ASC 805, we determined the fair value of the acquired assets and assumed liabilities related to the two properties acquired during the three months ended March 31, 2015, as follows (dollars in thousands):

|                | Land     | Building  | Tenant Improvements | In-place Leases | Leasing Costs | Customer Relationships | Above Market Leases | Total Purchase Price |
|----------------|----------|-----------|---------------------|-----------------|---------------|------------------------|---------------------|----------------------|
| Richardson, TX | \$ 2,709 | \$ 12,503 | \$ 2,761            | \$ 2,046        | \$ 1,791      | \$ 1,915               | \$ 975              | \$ 24,700            |
| Birmingham, AL | 650      | 1,683     | 351                 | 458             | 146           | 360                    |                     | 3,648                |
|                | \$ 3,359 | \$ 14,186 | \$ 3,112            | \$ 2,504        | \$ 1,937      | \$ 2,275               | \$ 975              | \$ 28,348            |

Below is a summary of the total revenue and earnings recognized on the two properties acquired during the three months ended March 31, 2015 (dollars in thousands):

| Location       | Acquisition Date | For the three months ended March 31, 2015 |                         |
|----------------|------------------|---|-------------------------|
|                |                  | Rental Revenue                            | Earnings <sup>(1)</sup> |
| Richardson, TX | 3/6/2015         | \$ 182                                    | \$ 51                   |
| Birmingham, AL | 3/20/2015        | 11  | 4                       |
|                |                  | \$ 193                                    | \$ 55                   |

- (1) Earnings is calculated as net income exclusive of both interest expense and acquisition related costs that are required to be expensed under ASC 805.

**Table of Contents***Pro Forma*

The following table reflects pro-forma consolidated statements of operations as if the properties acquired during the three months ended March 31, 2015 and the twelve months ended December 31, 2014, respectively were acquired as of January 1, 2014. The pro-forma earnings for the three months ended March 31, 2015 and 2014 were adjusted to assume that acquisition-related costs were incurred as of the previous period (dollars in thousands, except per share amounts):

|   | For the three months ended March 31,<br>(unaudited) |                         |
|---|---|-------------------------|
|   | 2015  | 2014                    |
| <b>Operating Data:</b>                                      |   |                         |
| Total operating revenue                                     | \$ 20,318   | \$ 20,789               |
| Total operating expenses                                    | (11,920)  | (26,282) <sup>(1)</sup> |
| Other expenses  | (7,546)   | (7,914)                 |
| Net income (loss)   | 852   | (13,407)                |
| Dividends attributable to preferred and senior common stock | (1,247)   | (1,123)                 |
| Net loss attributable to common stockholders                | \$ (395)  | \$ (14,530)             |
| <b>Share and Per Share Data:</b>                            |   |                         |
| Basic and diluted loss per share of common stock            | \$ (0.02)   | \$ (0.92)               |
| Weighted average shares outstanding-basic and diluted       | 20,210,975  | 15,746,714              |

<sup>(1)</sup> \$14.0 million relates to the impairment charge recorded in operating expenses during the three months ended March 31, 2014.

*Significant Real Estate Activity on Existing Assets*

On January 29, 2015, we modified leases with two tenants occupying space in our Indianapolis, Indiana property. One tenant, occupying 3,546 square feet, extended its lease term for an additional seven years, through March 2023. The original lease term would have expired in February 2016. This lease contains prescribed rent escalations over its life with annualized straight line rents of approximately \$0.06 million, unchanged from the previous lease. In connection with the extension of the lease and modification of certain of its terms, we provided \$0.06 million in tenant improvements. The other tenant, previously occupying 7,639 square feet, added an additional suite to its lease, increasing its leased square footage to 8,275. The lease expiration date is unchanged at January 2018. The new lease contains prescribed rent escalations over the life of the lease with annualized straight line rents of approximately \$0.1 million, a slight increase over the previous lease.

On February 9, 2015, we modified the leases with the tenant occupying two of our properties, both located in Raleigh, North Carolina. The leases covering these properties were extended for an additional five years each, through July 2020. Both leases were originally set to expire in July 2015. The tenant was previously fully occupying both

buildings, totaling 174,426 square feet, but had reduced its space requirement in the industrial building by 94,200 square feet. Both leases contain prescribed rent escalations over the life of the lease, with annualized straight line rents of approximately \$0.9 million, as compared to annualized straight line rents of \$1.3 million under the previous terms of the lease. The tenant has two options to renew both leases for an additional period of five years each. In connection with the extension of the lease and modification of certain terms of the lease, we paid \$0.2 million in leasing commissions, and paid \$0.1 million in tenant improvements.

On February 20, 2015, we entered into a purchase and sale agreement with a third party to acquire our Columbus, Ohio property for \$2.8 million, which is greater than the current carrying value of the property of \$2.4 million. The lease on this property is scheduled to terminate in October 2015 and the current tenant has notified us of its plan to vacate. We anticipate the sale to be completed in November 2015. We considered this asset to be non-core to our long term strategy, and we will re-deploy the proceeds from this sale into future acquisitions.

On February 27, 2015, we modified the lease with the tenant occupying our property located in San Antonio, Texas. The modification provided the tenant a termination option, which allows the tenant to terminate its lease effective December 31, 2017, upon paying a termination penalty of approximately \$1.0 million on or before March 31, 2017. All other terms and conditions of the lease remain in full force and effect.

**Table of Contents***2014 Real Estate Activity*

During the three months ended March 31, 2014, we acquired two properties, which are summarized in the table below (dollars in thousands):

| Location        | Acquisition Date | Square Footage | Lease Term | Renewal Options  | Total Purchase Price | Acquisition Expenses | Annualized Straight Line Rent | Debt Assumed    |
|-----------------|------------------|----------------|------------|------------------|----------------------|----------------------|-------------------------------|-----------------|
| Allen, TX       | 3/27/2014        | 21,154         | 12 Years   | 4 (5 years each) | \$ 5,525             | \$ 26                | \$ 570                        | \$ 3,481        |
| Colleyville, TX | 3/27/2014        | 20,355         | 12 Years   | 4 (5 years each) | 4,523                | 26                   | 467                           | 2,849           |
| <b>Total</b>    |                  | <b>41,509</b>  |            |                  | <b>\$ 10,048</b>     | <b>\$ 52</b>         | <b>\$ 1,037</b>               | <b>\$ 6,330</b> |

In accordance with ASC 805, we determined the fair value of the acquired assets related to the two properties acquired during the three months ended March 31, 2014 as follows (in thousands):

|                 | Land            | Building        | Tenant Improvements | In-place Leases | Leasing Costs | Customer Relationships | Below Market Leases | Discount on Debt Assumed | Total Purchase Price |
|-----------------|-----------------|-----------------|---------------------|-----------------|---------------|------------------------|---------------------|--------------------------|----------------------|
| Allen, TX       | \$ 874          | \$ 3,509        | \$ 125              | \$ 598          | \$ 273        | \$ 218                 | \$ 72               | \$ 72                    | \$ 5,525             |
| Colleyville, TX | 1,277           | 2,307           | 117                 | 486             | 220           | 181                    | 6                   | 59                       | \$ 4,523             |
|                 | <b>\$ 2,151</b> | <b>\$ 5,816</b> | <b>\$ 242</b>       | <b>\$ 1,084</b> | <b>\$ 493</b> | <b>\$ 399</b>          | <b>\$ 6</b>         | <b>\$ 131</b>            | <b>\$ 10,048</b>     |

Below is a summary of the total revenue and earnings recognized on the two properties acquired during the three months ended March 31, 2014 (dollars in thousands):

| Location        | Acquisition Date | For the three months ended March 31, 2014 |                         |
|-----------------|------------------|---|-------------------------|
|                 |                  | Rental Revenue                            | Earnings <sup>(1)</sup> |
| Allen, TX       | 3/27/2014        | \$ 8                                      | \$ 5                    |
| Colleyville, TX | 3/27/2014        | 6   | 4                       |
|                 |                  | <b>\$ 14</b>                              | <b>\$ 9</b>             |

(1) Earnings is calculated as net income exclusive of both interest expense and acquisition related costs that are required to be expensed under ASC 805.

**Table of Contents***Future Lease Payments*

Future operating lease payments from tenants under non-cancelable leases, excluding tenant reimbursement of expenses, for the remainder of 2015 and each of the five succeeding fiscal years and thereafter is as follows (dollars in thousands):

| Year                                 | Tenant<br>Lease Payments |
|--------------------------------------|--------------------------|
| Nine Months ending December 31, 2015 | \$ 55,082 <sup>(1)</sup> |
| 2016                                 | 72,558                   |
| 2017                                 | 72,269                   |
| 2018                                 | 71,974                   |
| 2019                                 | 72,429                   |
| 2020                                 | 64,164                   |
| Thereafter                           | 254,615                  |

<sup>(1)</sup> Does not include real estate held for sale as of March 31, 2015.

*Intangible Assets*

The following table summarizes the carrying value of intangible assets and the accumulated amortization for each intangible asset class as of March 31, 2015 and December 31, 2014 respectively (in thousands):

|                        | March 31, 2015 <sup>(1)</sup>         |                             | December 31, 2014                     |                             |
|------------------------|---------------------------------------|-----------------------------|---------------------------------------|-----------------------------|
|                        | Lease<br>Intangibles                  | Accumulated<br>Amortization | Lease<br>Intangibles                  | Accumulated<br>Amortization |
| In-place leases        | \$ 61,622                             | \$ (18,583)                 | \$ 59,233                             | \$ (17,379)                 |
| Leasing costs          | 40,361                                | (12,119)                    | 38,305                                | (11,411)                    |
| Customer relationships | 43,518                                | (11,991)                    | 41,243                                | (11,177)                    |
|                        | \$ 145,501                            | \$ (42,693)                 | \$ 138,781                            | \$ (39,967)                 |
|                        | Deferred Rent<br>Receivable/Liability | Accumulated<br>Amortization | Deferred Rent<br>Receivable/Liability | Accumulated<br>Amortization |
| Above market leases    | \$ 8,894                              | \$ (6,096)                  | \$ 8,314                              | \$ (6,384)                  |
| Below market leases    | 15,938                                | (7,564)                     | 15,939                                | (7,345)                     |
|                        | \$ 24,832                             | \$ (13,660)                 | \$ 24,253                             | \$ (13,729)                 |
| Total                  | \$ 170,333                            | \$ (56,353)                 | \$ 163,034                            | \$ (53,696)                 |



(1) Does not include real estate held for sale as of March 31, 2015.

The weighted average amortization periods in years for the intangible assets acquired and liabilities assumed during the three months ended March 31, 2015 and 2014, respectively, were as follows:

| Intangible Assets & Liabilities     | 2015 | 2014 |
|-------------------------------------|------|------|
| In-place leases                     | 9.1  | 11.9 |
| Leasing costs                       | 9.1  | 11.9 |
| Customer relationships              | 14.1 | 16.9 |
| Above market leases                 | 9.7  |      |
| Below market leases                 |      | 11.9 |
| All intangible assets & liabilities | 10.5 | 13.3 |

**Table of Contents**

The estimated aggregate amortization expense to be recorded for in-place leases, leasing costs, customer relationships and amortization of both above and below market leases for the remainder of 2015 and for each of the five succeeding fiscal years and thereafter is as follows (dollars in thousands):

| Year  | Estimated<br>Amortization Expense<br>of In-Place<br>Leases,<br>Leasing Costs<br>and<br>Customer<br>Relationships | Net Increase to Rental<br>Income Related to Above<br>and Below Market Leases |
|---|--|--|
| Nine Months Ending December 31, 2015 <sup>(1)</sup> | \$ 13,962  | \$ 228   |
| 2016  | 13,648   | 307  |
| 2017  | 12,167   | 429  |
| 2018  | 12,058   | 429  |
| 2019  | 12,051   | 429  |
| Thereafter  | 38,922   | 3,754  |
| <b>Total</b>  | <b>\$ 102,808</b>  | <b>\$ 5,576</b>  |

<sup>(1)</sup> Does not include real estate held for sale as of March 31, 2015.

**5. Real Estate Held for Sale***Real Estate Held for Sale*

As of March 31, 2015, we classified one of our properties located in Columbus, Ohio as held for sale under the provisions of ASC 360-10, which requires that the assets and liabilities of any such properties, be presented separately in our condensed consolidated balance sheet in the current period presented. We executed a purchase and sale agreement with the third party purchaser, and we anticipate the sale to close during November 2015. The agreed upon purchase price, net of expected costs to sell, is in excess of the carrying value of the property as of March 31, 2015, and thus the property was measured at its carrying value in our condensed consolidated balance sheet as of March 31, 2015 in accordance with ASC 360-10.

The table below summarizes the components of income from real estate and related assets held for sale:

|                   | For the three months ended March 31, |       |
|-------------------|--------------------------------------|-------|
|                   | 2015                                 | 2014  |
| Operating revenue | \$ 83                                | \$ 77 |
| Operating expense | 14                                   | 23    |
| Other expense     | 39                                   | 40    |

|  |    |    |    |    |
|--|----|----|----|----|
| Income from real estate and related assets held for sale | \$ | 30 | \$ | 14 |
|--|----|----|----|----|

**Table of Contents**

The table below summarizes the components of the assets and liabilities held for sale reflected on the accompanying condensed consolidated balance sheet:

|  | March 31, 2015  |
|--|-----------------|
| <b>ASSETS HELD FOR SALE</b>            |                 |
| Real estate, at cost                   | \$ 2,795        |
| Less: accumulated depreciation         | (615)           |
| Total real estate held for sale, net   | 2,180           |
| Lease intangibles, net                 | 17              |
| Funds held in escrow                   | 739             |
| Deferred rent receivable, net          | 32              |
| Deferred financing costs, net          | 9               |
| Other assets                           | 3               |
| <b>TOTAL ASSETS HELD FOR SALE</b>      | <b>\$ 2,980</b> |
| <b>LIABILITIES HELD FOR SALE</b>       |                 |
| Mortgage notes payable                 | 2,503           |
| Other liabilities                      | 84              |
| <b>TOTAL LIABILITIES HELD FOR SALE</b> | <b>\$ 2,587</b> |

**6. Mortgage Note Receivable**

On July 25, 2014, we closed a \$5.6 million second mortgage development loan for the construction of an 81,371 square foot, build-to-suit transitional care facility located on a major hospital campus in Phoenix, Arizona. Construction is scheduled to be completed in September 2015 and we will earn 9.0% interest, paid currently in cash, on the loan during construction and through maturity. Prior to completion of the facility, we will be granted a right of first offer to purchase the property at fair value. If we do not purchase the property we will receive an exit fee upon maturity of the loan in an amount sufficient for us to earn an internal rate of return of 22% on the second mortgage development loan, inclusive of interest earned. The loan is scheduled to mature in July 2016, but has a one-year extension option. We have recognized approximately \$0.3 million in both cash interest income and accrued exit fee revenue during the three months ended March 31, 2015.

**Table of Contents****7. Mortgage Notes Payable and Line of Credit**

Our mortgage notes payable and line of credit as of March 31, 2015 and December 31, 2014 are summarized below (dollars in thousands):

|  | Encumbered<br>properties<br>at<br>March 31, 2015 | Carrying Value at         |                   | Stated Interest<br>Rates at March 31,<br>2015 <sup>(4)</sup> | Scheduled Maturity<br>Dates at March 31,<br>2015 |
|--|--|---------------------------|-------------------|--|--|
|  |  | March 31, 2015            | December 31, 2014 |  |  |
| <b>Mortgage and Other Secured Loans:</b>               |  |                           |                   |  |  |
| Fixed rate mortgage loans                              | 74   | \$ 460,218 <sup>(5)</sup> | \$ 450,392        | (1)  | (2)  |
| Variable rate mortgage loans                           | 4  | 8,200                     | 8,200             | LIBOR + 2.15% <sup>(3)</sup>                                 | 12/1/2016  |
| Premiums and discounts (net)                           | N/A  | 630                       | 707               | N/A  | N/A  |
| <b>Total Mortgage Notes Payable</b>                    | <b>78</b>  | <b>\$ 469,048</b>         | <b>\$ 459,299</b> |  |  |
| Variable rate Line of Credit                           | 18   | 41,300                    | 43,300            | LIBOR + 2.75% <sup>(3)</sup>                                 | 8/1/2017   |
| <b>Total Mortgage Notes Payable and Line of Credit</b> | <b>96</b>  | <b>\$ 510,348</b>         | <b>\$ 502,599</b> |  |  |

(1) Interest rates on our fixed rate mortgage notes payable vary from 3.86% to 6.80%.

(2) We have 42 mortgage notes payable with maturity dates ranging from 9/1/2015 through 1/6/2039.

(3) At March 31, 2015, one month LIBOR was approximately 0.18%.

(4) The weighted average interest rate on all debt outstanding at March 31, 2015, was approximately 5.07%.

(5) Does not include mortgage notes payable related to assets held for sale of \$2.5 million.

N/A Not Applicable

*Mortgage Notes Payable*

As of March 31, 2015, we had 42 mortgage notes payable, collateralized by a total of 78 properties and the net book value of these collateralized properties was \$669.6 million. Gladstone Commercial Corporation 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 March 31, 2015 was 5.26%.

Edgar Filing: GLADSTONE COMMERCIAL CORP - Form 10-Q

During the three months ended March 31, 2015, we issued one long-term mortgage, collateralized by a single property, which is summarized below (dollars in thousands):

| Date of Issuance | Issuing Bank | Debt Issued | Interest Rate | Maturity Date |
|------------------|--------------|-------------|---------------|---------------|
| 3/6/2015         | PNC Bank, NA | \$ 14,573   | 3.86%         | 4/1/2025      |

**Table of Contents**

Scheduled principal payments of mortgage notes payable for the remainder of 2015, and each of the five succeeding fiscal years and thereafter are as follows (dollars in thousands):

| Year                                 | Scheduled Principal Payments |
|--------------------------------------|------------------------------|
| Nine Months ending December 31, 2015 | \$ 40,343 <sup>(1)</sup>     |
| 2016                                 | 96,812 <sup>(2)</sup>        |
| 2017                                 | 67,924                       |
| 2018                                 | 20,543                       |
| 2019                                 | 35,235                       |
| 2020                                 | 7,307                        |
| Thereafter                           | 200,254                      |
|                                      | \$ 468,418 <sup>(3)</sup>    |

- (1) We plan to refinance the 3 balloon principal payments that mature in the second half of 2015 with a combination of new mortgage debt and equity.
- (2) Does not include mortgage notes payable related to assets held for sale of \$2.5 million.
- (3) This figure is exclusive of premiums of premiums and discounts (net) on assumed debt, which were \$630 as of March 31, 2015.

**Interest Rate Cap**

We have entered into an interest rate cap agreement with Wells Fargo that caps the interest rate on the note payable for our Champaign, Illinois property at a certain interest rate when one-month LIBOR is in excess of 3.0%. The fair value of the interest rate cap agreement is recorded in Other assets on our accompanying condensed consolidated balance sheets. We record changes in the fair value of the interest rate cap agreement quarterly based on the current market valuations at quarter end as Other income (loss) on our accompanying condensed consolidated statements of operations. Generally, we will estimate the fair value of our interest rate cap using estimates of value provided by the counterparty and our own assumptions in the absence of observable market data, including estimated remaining life, counterparty credit risk, current market yield and interest rate spreads of similar securities as of the measurement date. At March 31, 2015 and December 31, 2014, our interest rate cap agreement was valued using Level 3 inputs. The following table summarizes the key terms of each interest rate cap agreement (dollars in thousands):

|                   | Notional Amount | LIBOR Cap | Maturity Date | As of March 31, 2015 |            | As of December 31, 2014 |            |
|-------------------|-----------------|-----------|---------------|----------------------|------------|-------------------------|------------|
|                   |                 |           |               | Cost                 | Fair Value | Cost                    | Fair Value |
| Interest Rate Cap |                 |           |               |                      |            |                         |            |
| November 26, 2013 | \$ 8,200        | 3.00%     | Dec-16        | \$ 31                | \$ 1       | \$ 31                   | \$ 4       |

**Fair Value**

The fair value of all mortgage notes payable outstanding as of March 31, 2015, excluding mortgage notes payable on real estate held for sale, was \$485.2 million, as compared to the carrying value stated above of \$469.0 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 and loan to value ratios. The fair value was calculated using Level 3 inputs of the hierarchy established by ASC 820, Fair Value Measurements and Disclosures.

*Line of Credit*

In August 2013, we procured a \$60.0 million senior unsecured revolving credit facility, or the Line of Credit, which was expanded to \$75.0 million in November 2014, with KeyBank National Association (serving as a revolving lender, a letter of credit issuer and an administrative agent) and added Citizens Bank of Pennsylvania as an additional lender. Comerica Bank was subsequently added as another lender in



## **Table of Contents**

December 2013. In March 2014, we amended our Line of Credit to extend the maturity date by one year to August 2017. We also modified certain terms under the Line of Credit, including the calculation of the total asset value and unencumbered asset value. The applicable LIBOR margins were also reduced 25 basis points at each pricing level. As a result of these modifications, the availability under our Line of Credit increased by \$1.3 million.

The Line of Credit initially matures in August 2017; however, we have a one-year extension option subject to the payment of an extension fee equal to 25 basis points on the initial maturity date and certain other customary conditions.

The Line of Credit has a letter of credit sublimit of up to \$20.0 million. In addition, we may expand the Line of Credit up to a total of \$100.0 million upon satisfaction of certain conditions and payment of the associated up front and arrangement fees at the time of such increase. 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 3.25%, 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 \$0.03 million per year and an unused commitment fee of 25 basis points per year, which accrues quarterly. 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 100% 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 the Line of Credit is based on a percentage of the value of a pool of unencumbered properties, which must meet agreed upon eligibility standards.

If and when long-term mortgages are arranged for properties in the unencumbered pool, the banks will reduce the availability under the Line of Credit by the amount advanced against that property's value. Conversely, as we purchase new properties meeting the eligibility standards, we may add these new properties to the unencumbered pool to obtain additional availability under the Line of Credit. The availability under the Line of Credit is also 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.

As of March 31, 2015, there was \$41.3 million outstanding under our Line of Credit at an interest rate of approximately 2.93% and \$4.5 million outstanding under letters of credit at a weighted average interest rate of 2.75%. As of May 4, 2015, the maximum additional amount we could draw was \$18.9 million. We were in compliance with all covenants under the Line of Credit as of March 31, 2015.

## **8. 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, or the 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 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 Global Select Market, or 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 costs on the condensed consolidated balance sheet and will be amortized through

interest expense 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 condensed consolidated statements of operations.

**Table of Contents**

The fair value of our Term Preferred Stock as of March 31, 2015, was \$39.9 million, as compared to the carrying value stated above of \$38.5 million. The fair value is calculated based on the closing share price as of March 31, 2015 of \$25.92. The fair value was calculated using Level 1 inputs of the hierarchy established by ASC 820, Fair Value Measurements and Disclosures.

**9. 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 for the remainder of 2015 and each of the five succeeding years and thereafter, are as follows (dollars in thousands):

| Location        | Lease End Date | For the year ended December 31, |        |        |        |        |        |          | Thereafter |
|-----------------|----------------|---------------------------------|--------|--------|--------|--------|--------|----------|------------|
|                 |                | 2015                            | 2016   | 2017   | 2018   | 2019   | 2020   |          |            |
| Tulsa, OK       | Apr-21         | \$ 127                          | \$ 169 | \$ 169 | \$ 169 | \$ 169 | \$ 169 | \$ 85    |            |
| Dartmouth, MA   | May-36         | 131                             | 174    | 174    | 174    | 174    | 174    | 3,126    |            |
| Springfield, MA | Feb-30         | 64                              | 86     | 89     | 90     | 90     | 90     | 884      |            |
|                 |                | \$ 322                          | \$ 429 | \$ 432 | \$ 433 | \$ 433 | \$ 433 | \$ 4,095 |            |

Expenses recorded in connection to rental expense incurred for the properties listed above during both the three months ended March 31, 2015 and 2014 were \$0.1 million, respectively. Rental expenses are reflected in property operating expenses on the condensed consolidated statements of operations.

**10. Stockholders Equity**

The following table summarizes the changes in our stockholders equity for the three months ended March 31, 2015 (dollars in thousands):

|   | Shares Issued   |                     |              | Preferred Common |       |       | Additional Paid in Capital | Notes Receivable from Employees | Distributions in Excess of Accumulated Earnings | Total Stockholders Equity |
|---|-----------------|---------------------|--------------|------------------|-------|-------|----------------------------|---------------------------------|---|---------------------------|
|   | Preferred Stock | Senior Common Stock | Common Stock | Stock            | Stock | Stock |                            |                                 |   |                           |
| Balance at December 31, 2014                          | 2,150,000       | 809,411             | 19,589,606   | \$ 2             | \$ 1  | \$ 20 | \$ 369,748                 | \$ (375)                        | \$ (151,724)                                    | \$ 217,672                |
| Issuance of senior common stock and common stock, net |                 | 192,546             | 870,081      |                  |       |       | 17,644                     |                                 | (8,853)   | 17,644                    |
|   |                 |                     |              |                  |       |       |                            |                                 | (8,853)   | (8,853)                   |

|  |           |           |            |      |      |       |            |          |              |            |     |
|--|-----------|-----------|------------|------|------|-------|------------|----------|--------------|------------|-----|
| Distributions declared to common, senior common and preferred stockholders |           |           |            |      |      |       |            |          |              |            |     |
| Net income   |           |           |            |      |      |       |            |          |              | 694        | 694 |
| Balance at March 31, 2015  | 2,150,000 | 1,001,957 | 20,459,687 | \$ 2 | \$ 1 | \$ 20 | \$ 387,392 | \$ (375) | \$ (159,883) | \$ 227,157 |     |

### *Distributions*

Our Board of Directors declared the following distributions per share for the three months ended March 31, 2015 and 2014:

|                          | For the three months ended March 31, |           |
|--------------------------|--------------------------------------|-----------|
|                          | 2015                                 | 2014      |
| Common Stock             | \$ 0.375                             | \$ 0.375  |
| Senior Common Stock      | 0.2625                               | 0.2625    |
| Series A Preferred Stock | 0.4843749                            | 0.4843749 |
| Series B Preferred Stock | 0.4688                               | 0.4688    |
| Series C Preferred Stock | 0.4453                               | 0.4453    |

**Table of Contents***Ongoing Activity*

On September 2, 2014 we entered into an open market sale agreement, or the ATM Program, with Cantor Fitzgerald & Co., or Cantor Fitzgerald, pursuant to which we may, from time to time, offer to sell shares of our common stock with an aggregate sales price of up to \$100.0 million on the open market through Cantor Fitzgerald, acting as sales agent and/or principal. During the three months ended March 31, 2015, we raised approximately \$15.1 million in net proceeds under the ATM Program. As of March 31, 2015, under the existing program, we have sold a total of 2.7 million shares with aggregate gross proceeds of \$47.8 million, and have a remaining capacity to sell up to \$52.2 million of common stock under the ATM Program with Cantor Fitzgerald.

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 were intended to be offered pursuant to the primary offering and 500,000 shares were intended to be offered pursuant to our senior common distribution reinvestment plan, or the DRIP. We elected not to extend this offering, which terminated according to its terms on March 28, 2015. During the three months ended March 31, 2015, we sold 189,052 shares of our Senior Common Stock at \$15.00 per share and issued 5,239 shares of our Senior Common Stock under the Dividend Reinvestment Plan, or DRIP, program. The net proceeds, after deducting the underwriting discount and commission, were \$2.6 million. At the conclusion of the offering on March 28, 2015, we had sold 927,994 shares of Senior Common Stock, for gross proceeds of \$13.9 million, and issued an additional 27,861 shares of Senior Common Stock under the DRIP program.

*Note to Employee*

The following table is a summary of the outstanding note issued to an employee of the Adviser for the exercise of stock options (dollars in thousands):

| Date Issued | Outstanding Balance of Employee Loan at |                   | Maturity Date of Note | Interest Rate on Note |
|-------------|---|-------------------|-----------------------|-----------------------|
|             | March 31, 2015                          | December 31, 2014 |                       |                       |
| Nov 2006    | \$ 375                                  | \$ 375            | Nov 2015              | 8.15%                 |

The employee stock option program terminated in 2006. 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, this note was recorded as a full recourse loan to the employee and is included in the equity section of the accompanying condensed consolidated balance sheets. As of March 31, 2015, this loan maintained its full recourse status.

**11. Subsequent Events**

On April 14, 2015, our Board of Directors declared the following monthly distributions:

| Record Date | Payment Date | Common Stock            | Series A Preferred      | Series B Preferred      | Series C Preferred      |
|-------------|--------------|-------------------------|-------------------------|-------------------------|-------------------------|
|             |              | Distributions per Share | Distributions per Share | Distributions per Share | Distributions per Share |
|             |              |                         |                         |                         |                         |

Edgar Filing: GLADSTONE COMMERCIAL CORP - Form 10-Q

|                |               |          |              |            |              |
|----------------|---------------|----------|--------------|------------|--------------|
| April 24, 2015 | May 5, 2015   | \$ 0.125 | \$ 0.1614583 | \$ 0.15625 | \$ 0.1484375 |
| May 19, 2015   | May 29, 2015  | 0.125    | 0.1614583    | 0.15625    | 0.1484375    |
| June 19, 2015  | June 30, 2015 | 0.125    | 0.1614583    | 0.15625    | 0.1484375    |
| Total          |               | \$ 0.375 | \$ 0.4843749 | \$ 0.46875 | \$ 0.4453125 |

**Table of Contents**

| Senior Common Stock Distributions                     |              |                        |
|---|--------------|------------------------|
| Payable to the Holders of Record During the Month of: | Payment Date | Distribution per Share |
| April   | May 7, 2015  | \$ 0.0875              |
| May   | June 5, 2015 | 0.0875                 |
| June  | July 8, 2015 | 0.0875                 |
| Total   |              | \$ 0.2625              |

*Phoenix, Arizona:* On April 14, 2015, we closed a \$0.3 million interim financing loan for the acquisition of land to be used for redevelopment and expansion of a medical center campus in Phoenix, Arizona. This loan is collateralized by proceeds from the sale of the transitional care facility for which we provided a mortgage development loan on July 25, 2014 (see Note 6). We will earn interest of 22% per annum through the maturity date, with all accrued interest and principal payable upon maturity. This loan matures upon the earlier of April 2016 or the sale of the transitional care facility, which is anticipated to occur in November 2015.

*Austin, Texas:* On April, 28 2015, we modified the lease with the tenant occupying one of our properties located in Austin, Texas. The modification provided the tenant a termination option, which allows the tenant to terminate its lease effective December 31, 2017, upon paying a termination penalty of approximately \$1.1 million on or before March 31, 2017. This modification forfeits the tenant's right to \$0.6 million in tenant improvement allowance, provided in an earlier amendment. All other terms and conditions of the lease remain in full force and effect.

---

**Table of Contents****Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

*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 Forward-Looking Statements and Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2014. 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.*

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

**General**

We are an externally-advised 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 98 properties totaling 10.8 million square feet, which have a total gross and net carrying value, including intangible assets and properties held for sale, of \$889.4 million and \$749.1 million, respectively. We also currently have one mortgage loan receivable outstanding for \$5.6 million.

**Business Environment**

The strength of the global economy and the U.S. economy in particular, continues to be uncertain and volatile, and we remain cautious about a long-term economic recovery. Vacancy rates have decreased for both office and industrial properties in most markets as increased user demand with restrained new construction activity has led to improved conditions. In fact, vacancy rates in many markets have been reduced to levels seen at the latest peak before the recession. Construction activity, particularly for industrial properties, is on the rise as a result of increased demand for facilities to satisfy the increased demand in the e-commerce sector. However, vacancy rates in certain secondary markets are still higher than pre-recession levels, as job growth has yet to return to all areas of the country even



though the national unemployment rate has dropped over the past 12 months. Interest rates have decreased since the beginning of the year and remain at historic lows. This continued low interest rate environment is leading to increasing competition for new acquisitions. In addition, the uncertainty surrounding the ability of the federal government to address its fiscal condition in both the near and long term has increased domestic and

## **Table of Contents**

global economic instability. These developments and our government's credit concerns in general, could cause interest rates and borrowing costs to rise, which may negatively impact our ability to access both the debt and equity markets on favorable terms. In addition, a further decrease to the U.S. credit rating could create broader financial turmoil and uncertainty, which may weigh heavily on our stock price. Continued adverse economic conditions could have a material adverse effect on one or more of our tenants, or our business, financial condition and results of operations.

We continue to focus on re-leasing vacant space, renewing upcoming lease maturities and acquiring additional properties. Currently, we have two fully vacant buildings located in Baytown, Texas and Newburyport, Massachusetts and one partially vacant building located in Bolingbrook, Illinois. Our Baytown, Texas tenant vacated upon its lease termination in April 2013 and our Newburyport, Massachusetts tenant vacated upon its lease termination in April 2015. Our Bolingbrook, Illinois tenant vacated upon their lease termination in December 2014 and we have a partial space tenant for this property, which took occupancy in December 2014. We originally had 12 leases expiring in 2015, and we have successfully extended the leases for 7 of these tenants, one in negotiation with the current tenant, and one in which we agreed to sell the property to a third party. We have been notified that 3 of the 12 tenants will leave. We are aggressively pursuing new tenants for the 3 properties of which the tenants are vacating. These properties comprise less than 3% of our projected 2015 rental income, and 50% of this income does not terminate until December 2015. While we originally had 12 leases expiring in 2015, we only have 4 leases expiring in 2016, 6 in 2017 and 4 in 2018, which are each less than 2% of annualized rents for each respective year.

Our available vacant space at March 31, 2015 comprises less than 0.5% of our total square footage and the annual carrying costs are approximately \$0.2 million. We continue to actively seek new tenants for these properties.

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 continues to improve and long-term mortgages are readily obtainable. The collateralized mortgage backed securities, or CMBS, market remains active but it is more conservative and restrictive than it was prior to the recession and uncertainty with regard to interest rates has made the CMBS market less predictable. We continue to look to regional banks, insurance companies and other non-bank lenders, in addition to the CMBS market to issue mortgages to finance our real estate activities.

In addition to obtaining funds through borrowing, we have been active in the equity markets during 2015. We have issued shares of common stock through our at-the-market program, or ATM Program, pursuant to our open market sale agreement with Cantor Fitzgerald & Co., or Cantor Fitzgerald, discussed in more detail below. In addition, we have issued shares of our convertible senior common stock, or the Senior Common Stock, also discussed in more detail below.

## **Recent Developments**

### *2015 Investment Activity*

*Richardson, Texas:* On March 6, 2015, we acquired a 155,984 square foot office building located in Richardson, Texas for \$24.7 million, excluding related acquisition expenses of \$0.1 million. We funded this acquisition with existing cash on hand and the issuance of \$14.6 million of mortgage debt on the property. The tenant has leased the property for 9.5 years and has 2 options to renew the lease for an additional 5 years each. The lease provides for prescribed rent escalations over the life of the lease, with annualized straight line gross rents of \$2.7 million.

*Birmingham, Alabama:* On March 20, 2015, we acquired a 30,850 square foot office building located in Birmingham, Alabama for \$3.6 million, excluding related acquisition expenses of \$0.1 million. We funded this acquisition with existing cash on hand. The tenant has leased the property for 8.5 years and has 1 option to renew the lease for an additional 5 years. The lease provides for prescribed rent escalations over the life of the lease, with annualized straight line rents of \$0.3 million.

---

**Table of Contents**

*Phoenix, Arizona:* On April 14, 2015, we closed a \$0.3 million interim financing loan for the acquisition of land to be used for redevelopment and expansion of a medical center campus in Phoenix, Arizona. This loan is collateralized by proceeds from the sale of the transitional care facility for which we provided a mortgage development loan on July 25, 2014 (see Note 6 in footnotes to the financial statements). We will earn interest of 22% per annum through the maturity date, with all accrued interest and principal payable upon maturity. This loan matures upon the earlier of April 2016 or the sale of the transitional care facility, which is anticipated to occur in November 2015.

*2015 Sale Activity*

*Columbus, Ohio:* On February 20, 2015, we entered into a purchase and sale agreement with a third party to acquire our Columbus, Ohio property for \$2.8 million, which is greater than the current carrying value of the property. The lease on this property is scheduled to terminate in October 2015 and the current tenant has notified us of its plan to vacate. We anticipate the sale to be completed in November 2015. We considered this asset to be non-core to our long term strategy, and we will re-deploy the proceeds from this sale into future acquisitions.

*2015 Financing Activity*

The following is a summary of our recent financings:

*PNC Bank:* On March 6, 2015, through a wholly-owned subsidiary, we borrowed \$14.6 million pursuant to a long-term note payable from PNC Bank National Association, which is collateralized by a security interest in one of our properties. The note accrued interest at a fixed rate of 3.86% per year and has a maturity date of April 1, 2025. We used the proceeds from the note to acquire the property in Richardson, Texas on the same date.

*2015 Leasing Activities*

*Indianapolis, Indiana:* On January 29, 2015, we modified leases with two tenants occupying space in our Indianapolis, Indiana property. One tenant, occupying 3,546 square feet, extended its lease term for an additional seven years, through March 2023. The original lease would have expired in February 2016. This lease contains prescribed rent escalations over its life with annualized straight line rents of approximately \$0.06 million, unchanged from the previous lease. In connection with the extension of the lease and modification of certain of its terms, we provided \$0.06 million in tenant improvements. The other tenant, previously occupying 7,639 square feet, added an additional suite to its lease, increasing its leased square footage to 8,275. The lease expiration date is unchanged at January 2018. The new lease contains prescribed rent escalations over the life of the lease with annualized straight line rents of approximately \$0.1 million, a slight increase over the previous lease.

*Raleigh, North Carolina:*

*Raleigh, North Carolina:* On February 9, 2015, we modified the leases with the tenant occupying two of our properties, both located in Raleigh, North Carolina. The leases covering these properties were extended for an additional five years each, through July 2020. Both leases were originally set to expire in July 2015. The tenant was previously fully occupying both buildings, totaling 174,426 square feet, but had reduced its space requirement in the industrial building by 94,200 square feet. Both leases contain prescribed rent escalations over the life of the lease, with annualized straight line rents of approximately \$0.9 million, as compared to annualized straight line rents of \$1.3 million under the previous terms of the lease. The tenant has two options to renew both leases for an additional period of five years each option. In connection with the extension of the lease and modification of certain terms of the lease, we paid \$0.2 million in leasing commissions, and paid \$0.1 million in tenant improvements.



**Table of Contents**

*San Antonio, Texas:* On February 27, 2015, we modified the lease with the tenant occupying our property located in San Antonio, Texas. The modification provided the tenant a termination option, which allows the tenant to terminate their lease effective December 31, 2017, upon paying a termination penalty of approximately \$1.0 million on or before March 31, 2017. All other terms and conditions of the lease remain in full force and effect.

*Austin, Texas:* On April, 28 2015, we modified the lease with the tenant occupying one of our properties located in Austin, Texas. The modification provided the tenant a termination option, which allows the tenant to terminate its lease effective December 31, 2017, upon paying a termination penalty of approximately \$1.1 million on or before March 31, 2017. This modification forfeits the tenant's right to \$0.6 million in tenant improvement allowance, provided in an earlier amendment. All other terms and conditions of the lease remain in full force and effect.

*2015 Equity Activities*

The equity issuances summarized below were issued under our universal shelf registration statement (File No. 333-190931) that was effective and on file with the Securities and Exchange Commission at the time of each respective issuance.

*ATM Programs:* During the three months ended March 31, 2015, we sold 0.9 million shares, raising an aggregate of \$15.1 million in net proceeds under our ATM Program with Cantor Fitzgerald. Proceeds from these sales were used to acquire real estate, repay indebtedness and for other general corporate purposes. Under the ATM Program we may, from time to time, offer to sell shares of our common stock with an aggregate sales price of up to \$100.0 million on the open market through Cantor Fitzgerald, as agent, or to Cantor Fitzgerald, as principal, based upon our instructions (including any price, time or size limits or other customary parameters or conditions that we may impose). We raised \$47.1 million in net proceeds under the ATM Program from September 2014 to date. Sales of shares of our common stock through our ATM Program are executed by means of ordinary brokers' transactions on the NASDAQ Global Select Market, or the NASDAQ, or otherwise at market prices, in privately negotiated transactions, crosses or block transactions, as may be agreed between us and Cantor Fitzgerald, including a combination of any of these transactions.

*Senior Common Equity:* During the three months ended March 31, 2015, we sold 189,052 shares of our Senior Common Stock at \$15.00 per share and issued 5,239 shares of our Senior Common Stock under the Dividend Reinvestment Plan, or DRIP, program. The net proceeds, after deducting the underwriting discount and commission, were \$2.6 million. This offering terminated according to its terms on March 28, 2015, and we wrote-off \$0.1 million of deferred offering costs related to such termination. Proceeds from this offering were used to acquire real estate and for general corporate purposes.

**Table of Contents****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 three months ended March 31, 2015 and 2014, respectively (dollars in thousands):

| Industry Classification                     | For the three months ended March 31,<br>2015 |                                | For the three months ended March 31,<br>2014 |                                |
|---|--|--------------------------------|--|--------------------------------|
|   | Rental Income                                | Percentage of<br>Rental Income | Rental Income                                | Percentage of<br>Rental Income |
| Telecommunications                          | \$ 3,128                                     | 16.1%                          | \$ 3,069                                     | 18.5%                          |
| Healthcare                                  | 2,644  | 13.7                           | 1,875  | 11.3                           |
| Automobile                                  | 2,635  | 13.7                           | 2,296  | 13.8                           |
| Personal, Food & Miscellaneous Services     | 1,576  | 8.2                            | 1,332  | 8.0                            |
| Electronics                                 | 1,202  | 6.2                            | 1,378  | 8.3                            |
| Diversified/Conglomerate Services           | 1,167  | 6.1                            | 311  | 1.9                            |
| Diversified/Conglomerate Manufacturing      | 1,042  | 5.4                            | 916  | 5.5                            |
| Chemicals, Plastics & Rubber                | 789  | 4.1                            | 839  | 5.1                            |
| Machinery                                   | 772  | 4.0                            | 583  | 3.5                            |
| Beverage, Food & Tobacco                    | 748  | 3.9                            | 748  | 4.5                            |
| Personal & Non-Durable Consumer<br>Products | 657  | 3.4                            | 651  | 3.9                            |
| Childcare                                   | 556  | 2.9                            | 160  | 1.0                            |
| Buildings and Real Estate                   | 548  | 2.8                            | 542  | 3.3                            |
| Containers, Packaging & Glass               | 521  | 2.7                            | 521  | 3.1                            |
| Printing & Publishing                       | 391  | 2.0                            | 460  | 2.8                            |
| Oil & Gas                                   | 327  | 1.7                            | 319  | 1.9                            |
| Banking                                     | 289  | 1.5                            | 289  | 1.7                            |
| Education                                   | 164  | 0.9                            | 164  | 1.0                            |
| Home & Office Furnishings                   | 132  | 0.7                            | 132  | 0.8                            |
|   | \$ 19,288                                    | 100.0%                         | \$ 16,585                                    | 100.0%                         |

The table below reflects the breakdown of total rental income by state for the three months ended March 31, 2015 and 2014, respectively (dollars in thousands):

| State          | For the three months ended March 31, 2015 |               |                  | For the three months ended March 31, 2014 |               |                  |
|----------------|---|---------------|------------------|---|---------------|------------------|
|                | Rental Revenue                            | % of Base Ren | Number of Leases | Rental Revenue                            | % of Base Ren | Number of Leases |
| Texas          | \$ 3,211                                  | 16.6%         | 11               | \$ 2,535                                  | 15.3%         | 9                |
| Ohio           | 2,493                                     | 12.9          | 17               | 2,319                                     | 14.0          | 14               |
| Pennsylvania   | 1,655                                     | 8.6           | 6                | 806                                       | 4.9           | 5                |
| North Carolina | 1,340                                     | 7.0           | 7                | 1,210                                     | 7.3           | 7                |

Edgar Filing: GLADSTONE COMMERCIAL CORP - Form 10-Q

|                  |                  |               |           |                  |               |           |
|------------------|------------------|---------------|-----------|------------------|---------------|-----------|
| South Carolina   | 1,115            | 5.8           | 2         | 1,115            | 6.7           | 2         |
| Michigan         | 1,074            | 5.6           | 4         | 736              | 4.4           | 3         |
| Minnesota        | 819              | 4.2           | 3         | 1,180            | 7.1           | 4         |
| Colorado         | 813              | 4.2           | 3         | 376              | 2.3           | 1         |
| New Jersey       | 798              | 4.1           | 4         | 792              | 4.8           | 4         |
| All Other States | 5,970            | 31.0          | 36        | 5,516            | 33.2          | 26        |
| <b>Total</b>     | <b>\$ 19,288</b> | <b>100.0%</b> | <b>93</b> | <b>\$ 16,585</b> | <b>100.0%</b> | <b>75</b> |

### Our Adviser and Administrator

Our Adviser is led by a management team with 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. Mr. Terry Lee Brubaker, our vice chairman and chief operating officer, is also the vice chairman and chief operating officer of our Adviser. Mr. Robert Cutlip, our president, is also an executive managing director of our Adviser. Gladstone Administration, LLC, or our Administrator, employs our chief financial officer, treasurer, chief compliance officer, general counsel and secretary (who also serves as our Administrator's president) and their respective staffs. Mr. Gladstone is also the chairman and chief executive officer of our Administrator and Mr. Brubaker is the vice chairman and chief operating officer of our Administrator.

Our Adviser and Administrator also provide investment advisory and administrative services, respectively, to certain of 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 publicly-traded REIT that primarily invests in farmland. With the exception of Ms. Danielle Jones, our chief financial officer, Mr. Jay Beckhorn, our treasurer, and Mr. Robert Cutlip, our president, all of our executive officers and all of our directors serve as either directors or executive officers, or both, of Gladstone Capital Corporation and Gladstone Investment Corporation. In addition, with the exception of our president and our chief financial officer, all of our executive officers and all of our directors, with the exception of Mr. David Dullum, serve as either directors or executive officers, or both, of Gladstone Land Corporation. In the future, our Adviser may provide investment advisory services to other companies, both public and private.



## Table of Contents

### **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 investment 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 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).

#### *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 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; however, our Adviser may earn fee income from our borrowers or tenants or other sources.

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 quarterly 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

## **Table of Contents**

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 100% of FFO with acquisition-related costs that are required to be expensed under 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 months ended March 31, 2015, and 2014, 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, treasurer, chief compliance officer, general counsel and secretary (who also serves as our Administrator's president), and their respective staffs. Prior to July 1, 2014, our allocable portion was generally derived by multiplying that portion of the Administrator's expenses allocable to all funds managed by the Adviser by the percentage of our total assets at the beginning of each quarter in comparison to the total assets of all funds managed by the Adviser. As approved by our Board of Directors, effective July 1, 2014, our allocable portion of the Administrator's expenses will generally be derived by multiplying our Administrator's total expenses by the approximate percentage of time the Administrator's employees perform services for us in relation to their time spent performing services for all companies serviced by our Administrator under contractual agreements. Management believes that the new methodology of allocating the Administrator's total expenses by approximate percentage of time services were performed among all companies serviced by our Administrator more closely approximates fees paid to actual services performed.

### **Critical Accounting Policies**

The preparation of our financial statements in accordance with Generally Accepted Accounting Principles in the U.S., or GAAP, requires management to make judgments that are subjective in nature in order to make certain estimates and assumptions. 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. There were no material changes to our critical accounting policies during the three months ended March 31, 2015.

#### *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 and 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 in accordance with ASC 805, Business Combinations. All expenses related to the acquisition are expensed as incurred.

Our Adviser estimates value 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. Our Adviser also considers 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,

## Table of Contents

depending on specific local market conditions. Our Adviser 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. Our Adviser 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, our Adviser 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 indicate 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 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, we evaluated our entire portfolio as of March 31, 2015, for any impairment indicators and performed an impairment analysis on those select properties that had an indication of impairment. In our analysis, we have determined that no properties in our portfolio were impaired as of March 31, 2015. During the

quarter ended March 31, 2014, we concluded that our Roseville, Minnesota property was impaired. Accordingly, we reduced the carrying value of this property to its estimated fair value, less cost to sell, and we recognized an impairment loss of \$14.0 million during the three months ended March 31, 2014. This property was returned to the lender in a deed-in-lieu transaction on November 12, 2014.

**Table of Contents**

Our property located in Dayton, Ohio is at risk to become impaired in the future. The lease with the tenant in this property terminates on June 30, 2015. There is a possibility we may have to impair this property in 2015 if we do not find a replacement tenant.

We will continue to monitor our portfolio for any other indicators of impairment. There have been no other impairments recognized on our real estate assets since inception.

**Table of Contents****Results of Operations**

The weighted-average yield on our total portfolio, which was 8.81% and 9.0% as of March 31, 2015 and March 31, 2014, respectively, 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 cost. The weighted-average yield does not account for the interest expense incurred on the mortgages placed on our properties.

*A comparison of our operating results for the three months ended March 31, 2015 and 2014 is below (dollars in thousands, except per share amounts):*

|   | For the three months ended March 31, |                 |                 |              |
|---|--------------------------------------|-----------------|-----------------|--------------|
|   | 2015                                 | 2014            | \$<br>Change    | % Change     |
| <b>Operating revenues</b>   |                                      |                 |                 |              |
| Rental revenue  | \$ 19,288                            | \$ 16,585       | \$ 2,703        | 16%          |
| Tenant recovery revenue   | 324                                  | 551             | (227)           | (41)         |
| Interest income from mortgage note receivable                                 | 268                                  |                 | 268             | NM           |
| <b>Total operating revenues</b>   | <b>19,880</b>                        | <b>17,136</b>   | <b>2,744</b>    | <b>16</b>    |
| <b>Operating expenses</b>   |                                      |                 |                 |              |
| Depreciation and amortization   | 8,207                                | 6,720           | 1,487           | 22           |
| Property operating expenses   | 962                                  | 1,330           | (368)           | (28)         |
| Acquisition related expenses  | 196                                  | 110             | 86              | 78           |
| Base management fee   | 852                                  | 625             | 227             | 36           |
| Incentive fee   | 1,673                                | 1,240           | 433             | 35           |
| Administration fee  | 362                                  | 492             | (130)           | (26)         |
| General and administrative  | 690                                  | 466             | 224             | 48           |
| Impairment charge   |                                      | 13,958          | (13,958)        | NM           |
| <b>Total operating expenses before credit to incentive fee</b>                | <b>12,942</b>                        | <b>24,941</b>   | <b>(11,999)</b> | <b>(48)</b>  |
| Credit to incentive fee   | (1,185)                              | (1,205)         | 20              | (2)          |
| <b>Total operating expenses</b>   | <b>11,757</b>                        | <b>23,736</b>   | <b>(11,979)</b> | <b>(50)</b>  |
| <b>Other income (expense)</b>   |                                      |                 |                 |              |
| Interest expense  | (6,771)                              | (6,275)         | (496)           | 8            |
| Distributions attributable to Series C mandatorily redeemable preferred stock | (686)                                | (686)           |                 |              |
| Other income  | 28                                   | 47              | (19)            | (40)         |
| <b>Total other expense</b>  | <b>(7,429)</b>                       | <b>(6,914)</b>  | <b>(515)</b>    | <b>7</b>     |
| <b>Net income (loss)</b>  | <b>694</b>                           | <b>(13,514)</b> | <b>14,208</b>   | <b>(105)</b> |



|   |           |             |           |      |
|---|-----------|-------------|-----------|------|
| Distributions attributable to Series A and B preferred stock                                    | (1,023)   | (1,023)     |           |      |
| Distributions attributable to senior common stock   | (224)     | (100)       | (124)     | 124  |
| Net loss attributable to common stockholders  | \$ (553)  | \$ (14,637) | \$ 14,084 | (96) |
| Net loss attributable to common stockholders per weighted average share of common stock diluted | \$ (0.03) | \$ (0.93)   | \$ 0.90   | (97) |
| FFO available to common stockholders  | \$ 7,654  | \$ 6,041    | \$ 1,613  | 27   |
| FFO per weighted average share of common stock diluted  | \$ 0.37   | \$ 0.38     | \$ (0.01) | (3)  |

NM = Not meaningful

### *Operating Revenues*

Rental revenue increased for the three months ended March 31, 2015, as compared to the three months ended March 31, 2014, because we acquired two properties during the three months ended March 31, 2015, combined with a full quarter of revenue for properties acquired during 2014. On a same-property basis, which only includes properties owned for the entirety of both periods presented and excludes properties sold during 2014 or marked as held for sale in 2015, rental revenue decreased by approximately \$131,000, or 0.8%, for the three months ended March 31, 2015, due to renewals of existing leases or new leases being put in place at lower rental rates.

Tenant recovery revenue decreased for the three months ended March 31, 2015, as compared to the three months ended March 31, 2014. This decrease was primarily due to the 2015 period's lack of operating expense recoveries associated with our Roseville, Minnesota property, which was conveyed to the lender in a deed-in-lieu transaction during 2014. On a same-property basis, which only includes properties owned for the entirety of both periods presented and excludes properties sold during 2014 or marked as held for sale in 2015, tenant recovery revenue increased by \$0.2 million or 61% for the three months ended March 31, 2015, due to an increase in properties acquired in the past 12 months that are subject to gross leases.

---

**Table of Contents**

Interest income from mortgage note receivable increased for the three months ended March 31, 2015, as compared to the three months ended March 31, 2014, because of interest earned on a mortgage development loan issued in July 2014 that was not outstanding during the three months ended March 31, 2014.

*Operating Expenses*

Depreciation and amortization expenses increased for the three months ended March 31, 2015, as compared to the three months ended March 31, 2014, because of the two properties acquired during 2015 and the inclusion of a full quarter of depreciation recorded in 2015 for 11 properties acquired in 2014. On a same-property basis, depreciation and amortization expense increased by approximately \$0.2 million, or 2.8%, for the three months ended March 31, 2015.

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 decreased for the three months ended March 31, 2015, as compared to the three months ended March 31, 2014, primarily because of a decrease in vacancies in our portfolio, coupled with a lack of operating expenses in 2015 associated with our Roseville, Minnesota property, which was conveyed to the lender in a deed-in-lieu transaction during 2014, offset by certain properties acquired during 2014 and 2015 that are subject to a base year or gross lease. On a same-property basis, which only includes properties owned for the entirety of both periods presented and excludes properties sold during 2014 or marked as held for sale in 2015, property operating expenses increased by \$0.04 million or 7.1% for the three months ended March 31, 2015, due to an increase in properties acquired in the past 12 months that are subject to gross leases. This increase is offset by an increase in tenant recovery revenues discussed above.

Acquisition related expenses primarily consist of legal fees and fees incurred for third-party reports prepared in connection with potential acquisitions and our due diligence analyses related thereto. Acquisition related expenses increased for the three months ended March 31, 2015, as compared to the three months ended March 31, 2014, as a result of acquiring properties with greater acquisition prices during the three months ended March 31, 2015 as compared to the three months ended March 31, 2014.

The base management fee increased for the three months ended March 31, 2015, as compared to the three months ended March 31, 2014, due to an increase in total common stockholders' equity, the main component of the calculation. The calculation of the base management fee is described in detail above within *Advisory and Administration Agreements*.

The incentive fee increased for the three months ended March 31, 2015, as compared to the three months ended March 31, 2014, because of an increase in pre-incentive fee FFO. The increase in pre-incentive fee FFO was due to an increase in rental revenues from the properties acquired during the three months ended March 31, 2015, in conjunction with a decrease in property operating expenses during the three months ended March 31, 2015, as compared to the three months ended March 31, 2014. The incentive fee credit decreased slightly for the three months ended March 31, 2015, as compared to the three months ended March 31, 2014, because of an increase in total operating revenues from the properties acquired subsequent to March 31, 2015 partially offset by the amount of common distributions paid on the shares issued during the past year coupled with higher expenses at our vacant properties. The calculation of the incentive fee is described in detail above within *Advisory and Administration Agreements*.

The administration fee decreased for the three months ended March 31, 2015, as compared to the three months ended March 31, 2014. The decrease was driven primarily by a decrease in the amount of the fee allocated to us by our Administrator because the allocation of the fee was revised in July 2014 such that the fee is generally now based upon the percentage of time employees of the Administrator spend on our matters in relation to time spent on other

companies serviced by our Administrator versus the prior methodology, whereby we were generally allocated the fee based upon our total assets in relation to other funds managed by our Administrator. We anticipate our future administration fees to be lower than in 2014 under the new methodology. The calculation of the administration fee is described in detail above within *Advisory and Administration Agreements*.

## **Table of Contents**

General and administrative expenses increased for the three months ended March 31, 2015, as compared to the three months ended March 31, 2014, primarily as a result of an increase in professional fees from the write-off of costs associated with our terminated offering of Senior Common Stock.

We did not recognize an impairment charge during the three months ended March 31, 2015. The impairment charge recognized during the three months ended March 31, 2014 was a result of the impairment of our Roseville, Minnesota property.

### *Other Income and Expenses*

Interest expense increased for the three months ended March 31, 2015, as compared to the three months ended March 31, 2014. This increase was primarily a result of interest on the \$70.5 million of mortgage debt issued and assumed in the past 12 months, partially offset by reduced interest expense on our long-term financings from amortizing and balloon principal payments made during the past 12 months.

Other income decreased during the three months ended March 31, 2015, as compared to the three months ended March 31, 2014, because of a decrease in management fees collected from certain of our tenants.

### *Net Loss Attributable to Common Stockholders*

Net loss attributable to common stockholders decreased for the three months ended March 31, 2015, as compared to the three months ended March 31, 2014, primarily because of the impairment charge from the Roseville, Minnesota property in 2014 offset by increased interest expense, depreciation expense, and an increase in rental income from the properties acquired over the past 12 months.

## **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 issuances of equity securities. Our available liquidity at March 31, 2015 was \$18.3 million, including \$5.8 million in cash and cash equivalents and an available borrowing capacity of \$12.5 million under our Line of Credit.

### *Future Capital Needs*

We actively seek conservative investments that are likely to produce income to pay distributions to our stockholders. We intend to use the proceeds received from 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 on borrowings under our Line of Credit, 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 borrowings under our Line of Credit and fund our current operating costs in the near term. Additionally, to satisfy our short-term obligations, we may request 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. Historically, our Adviser has provided such partial credits to our management fees on a quarterly basis. 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.

## **Table of Contents**

### *Equity Capital*

Thus far in 2015, we have raised net proceeds of \$20.0 million of common equity under our ATM program with Cantor Fitzgerald at a weighted average share price of \$17.82. Furthermore, we raised \$2.5 million in net proceeds of senior common equity. We used these proceeds to acquire additional real estate and for general corporate purposes.

As of May 4, 2015, we have the ability to raise up to \$176.5 million of additional equity capital through the sale and issuance of securities that are registered under our universal shelf registration statement on Form S-3 (File No. 333-190931), or the Universal Shelf, in one or more future public offerings. Of the \$176.5 million of available capacity under our Universal Shelf, \$47.1 million of common stock is reserved for additional sales under our ATM Program. We believe that our ATM program is a sufficient source of liquidity for 2015.

### *Debt Capital*

As of March 31, 2015, we had mortgage notes payable in the aggregate principal amount of \$469.0 million, excluding mortgage notes payable on real estate assets held for sale, collateralized by a total of 78 properties with terms at issuance ranging from 4 years to 25 years. The weighted-average interest rate on the mortgage notes payable as of March 31, 2015 was 5.26%.

The CMBS market has recovered from the recent recession; see the discussion in *Business Environment* above. Specifically, we continue to see banks and other non-bank lenders willing to issue 10-year mortgages. Consequently, we are focused on obtaining mortgages through regional banks, non-bank lenders and the CMBS market.

We have mortgage debt in the aggregate principal amount of \$40.4 million payable during the remainder of 2015 and \$96.8 million payable during 2016, excluding balloon payments on real estate assets held for sale. The 2015 principal amounts payable include both amortizing principal payments and 3 balloon principal payments due in the second half of the year. We anticipate being able to refinance the mortgages that come due during 2015 and 2016 with a combination of new mortgage debt and the issuance of additional equity securities.

### *Operating Activities*

Net cash provided by operating activities during the three months ended March 31, 2015, was \$8.9 million, as compared to net cash provided by operating activities of \$6.2 million for the three months ended March 31, 2014. This increase was primarily a result of an increase in rental income received from the properties acquired in the past 12 months, partially offset by the increase in general and administrative expenses as a result of increased activity in our portfolio. 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 three months ended March 31, 2015, was \$30.7 million, which primarily consisted of the acquisition of two properties and tenant improvements performed at certain of our properties, as compared to net cash used in investing activities during the three months ended March 31, 2014, of \$6.3 million, which primarily consisted of the acquisition of two properties, coupled with tenant improvements performed at certain of our properties.



## **Table of Contents**

### *Financing Activities*

Net cash provided by financing activities during the three months ended March 31, 2015, was \$18.9 million, which primarily consisted of proceeds from the sale of common stock and proceeds from the issuance of mortgage notes payable, partially offset by the increase in distributions paid to our stockholders, net repayments under our line of credit and principal repayments on mortgage notes payable. Net cash used in financing activities for the three months ended March 31, 2014, was \$2.6 million, which primarily consisted of distributions paid to our stockholders and principal repayments on mortgage notes payable, partially offset by proceeds from the sale of common stock.

### *Line of Credit*

In August 2013, we procured our \$60.0 million Line of Credit, which was expanded to \$75.0 million in November 2014, with KeyBank National Association (serving as a revolving lender, a letter of credit issuer and an administrative agent) and added Citizens Bank of Pennsylvania as an additional lender. Comerica Bank was subsequently added as another lender in December 2013. In March 2014, we amended our Line of Credit to extend the maturity date by one year to August 2017. We also modified certain terms under the Line of Credit, including the calculation of the total asset value and unencumbered asset value. The applicable LIBOR margins were also reduced 25 basis points at each pricing level. As a result of these modifications, the availability under our Line of Credit increased by \$1.3 million.

The Line of Credit initially matures in August 2017; however, we have a one-year extension option subject to the payment of an extension fee equal to 25 basis points on the initial maturity date and certain other customary conditions.

The Line of Credit has a letter of credit sublimit of up to \$20.0 million. In addition, we may expand the Line of Credit up to a total of \$100.0 million upon satisfaction of certain conditions and payment of the associated up front and arrangement fees at the time of such increase. 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 3.25%, 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 \$0.03 million per year and an unused commitment fee of 25 basis points per year, which accrues quarterly. 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 100% 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 the Line of Credit is based on a percentage of the value of a pool of unencumbered properties, which must meet agreed upon eligibility standards.

If and when long-term mortgages are arranged for properties in the unencumbered pool, the banks will reduce the availability under the Line of Credit by the amount advanced against that property's value. Conversely, as we purchase new properties meeting the eligibility standards, we may add these new properties to the unencumbered pool to obtain additional availability under the Line of Credit. The availability under the Line of Credit is also 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 properties.

As of March 31, 2015, there was \$41.3 million outstanding under our Line of Credit at an interest rate of approximately 2.93% and \$4.5 million outstanding under letters of credit at a weighted average interest rate of 2.75%. As of May 4, 2015, the maximum additional amount we could draw was \$18.9 million. We were in compliance with all covenants under the Line of Credit as of March 31, 2015.





**Table of Contents****Contractual Obligations**

The following table reflects our material contractual obligations as of March 31, 2015 (in thousands):

| Contractual Obligations                     | Total             | Payments Due by Period   |                   |                  |                   |
|---|-------------------|--------------------------|-------------------|------------------|-------------------|
|   |                   | Less than 1 Year         | 1-3 Years         | 3-5 Years        | More than 5 Years |
| Debt Obligations <sup>(1)</sup>             | \$ 548,218        | \$ 63,202 <sup>(5)</sup> | \$ 223,611        | \$ 55,648        | \$ 205,757        |
| Interest on Debt Obligations <sup>(2)</sup> | 118,011           | 26,350                   | 36,135            | 23,381           | 32,145            |
| Operating Lease Obligations <sup>(3)</sup>  | 6,577             | 429                      | 862               | 867              | 4,419             |
| Purchase Obligations <sup>(4)</sup>         | 4,009             | 3,889                    | 120               |                  |                   |
| <b>Total</b>                                | <b>\$ 676,815</b> | <b>\$ 93,870</b>         | <b>\$ 260,728</b> | <b>\$ 79,896</b> | <b>\$ 242,321</b> |

- (1) Debt obligations represent borrowings under our Line of Credit, which represents \$41.3 million of the debt obligation due in 2017, mortgage notes payable that were outstanding as of March 31, 2015, and amounts due to the holders of 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 to the holders of 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 March 31, 2015.
- (3) Operating lease obligations represent the ground lease payments due on our Tulsa, Oklahoma, Dartmouth, Massachusetts, and Springfield, Missouri properties.
- (4) Purchase obligations consist of \$1.2 million to fund tenant improvements at two of our Ohio properties, \$1.3 million in tenant improvements at our Burnsville, MN property, \$0.8 million of tenant improvements at our Austin, TX property, \$0.5 million of tenant improvements at our Bolingbrook, IL property, \$0.1 million of tenant improvements at our Raleigh, NC property, and \$0.1 million of tenant improvements at our Indianapolis, IN property. These items were recognized on our balance sheet for the three months ended March 31, 2015.
- (5) Does not include mortgage notes payable related to assets held for sale of \$2.5 million.

**Off-Balance Sheet Arrangements**

We did not have any off-balance sheet arrangements as of March 31, 2015.

**Funds from Operations**

The National Association of Real Estate Investment Trusts, or NAREIT, developed FFO as a relevant non-GAAP supplemental measure of operating performance of an equity REIT, 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.

**Table of Contents**

The following table provides a reconciliation of our FFO available to common stockholders for the three months ended March 31, 2015 and 2014, to the most directly comparable GAAP measure, net income available to common stockholders, and a computation of basic and diluted FFO per weighted average share of common stock:

|   | For the three months ended March 31,<br>(Dollars in Thousands, Except for Per Share Amounts) |             |
|---|--|-------------|
|   | 2015   | 2014        |
| Net income (loss)   | \$ 694   | \$ (13,514) |
| Less: Distributions attributable to preferred and senior common stock | (1,247)  | (1,123)     |
| Net loss attributable to common stockholders                          | \$ (553)   | \$ (14,637) |
| Adjustments:  |  |             |
| Add: Real estate depreciation and amortization                        | 8,207  | 6,720       |
| Add: Impairment charge  |  | 13,958      |
| FFO available to common stockholders                                  | \$ 7,654   | \$ 6,041    |
| Weighted average common shares outstanding basic                      | 20,210,975   | 15,746,714  |
| Weighted average common shares outstanding diluted                    | 20,934,606   | 16,063,693  |
| Basic FFO per weighted average share of common stock                  | \$ 0.38  | \$ 0.38     |
| Diluted FFO per weighted average share of common stock                | \$ 0.37  | \$ 0.38     |
| Distributions declared per share of common stock                      | \$ 0.375   | \$ 0.375    |

**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. Certain of our leases contain escalations based on market indices, and the interest rate on our 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. To that end, we have entered into a derivative contract with Wells Fargo to cap interest rates for the variable rate note payable on our Champaign, Illinois property. We paid a fee of \$0.03 million to cap LIBOR rates at 3.0%, to limit our exposure to interest rates on this note payable.

To illustrate the potential impact of changes in interest rates on our net income for the year ended March 31, 2015, 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.

The following table summarizes the annual impact of a 1%, 2% and 3% increase in the one month LIBOR as of December 31, 2014. As of March 31, 2015, our effective average LIBOR was 0.18%; thus, a 1%, 2% or 3% decrease could not occur.

| Interest Rate Change | (Dollars in Thousands)       |                            |
|----------------------|------------------------------|----------------------------|
|                      | Increase to Interest Expense | Net Decrease to Net Income |
| 1% Increase to LIBOR | \$ 502                       | \$ (502)                   |
| 2% Increase to LIBOR | 1,004                        | (1,004)                    |
| 3% Increase to LIBOR | 1,464                        | (1,464)                    |

As of March 31, 2015, the fair value of our mortgage debt outstanding, excluding real estate held for sale, was \$485.2 million. Interest rate fluctuations may affect the fair value of our debt instruments. If interest rates on our debt instruments, using rates at March 31, 2015, had been one percentage point higher or lower, the fair value of those debt instruments on that date would have decreased or increased by \$26.3 million and \$11.3 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 March 31, 2015, our management, including our chief executive officer and chief financial officer, evaluated the effectiveness of the design and operation of our disclosure controls and procedures. 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 March 31, 2015 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 March 31, 2015 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.**

We are not currently subject to any material legal proceedings, nor, to our knowledge, is any material legal proceeding threatened against us.

**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, 2014, filed by us with the Securities and Exchange Commission on February 18, 2015.

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

*Sales of Unregistered Securities*

None.

*Issuer Purchases of Equity Securities*

None.

**Item 3. Defaults Upon Senior Securities**

None.

**Item 4. Mine Safety Disclosures**

Not applicable.

**Item 5. Other Information**

None.

**Item 6. Exhibits**

**Table of Contents****Exhibit Index**

| <b>Exhibit Number</b> | <b>Exhibit Description</b>   |
|-----------------------|--|
| 3.1                   | Articles of Restatement of the Registrant, incorporated by reference to Exhibit 3.1 to the Registrant's Quarterly Report on 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 Registrant's Registration Statement on Form S-11 (File No. 333-106024), filed June 11, 2003.   |
| 3.3                   | First Amendment to Bylaws of the Registrant, incorporated by reference to Exhibit 99.1 to 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 Pre-Effective Amendment No. 2 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 to 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 to 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 the Registrant, incorporated by reference to Exhibit 4.4 to the Registrant's 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  |



**Table of Contents**

|            |  |
|------------|--|
| 101.CAL*** | XBRL Taxonomy Extension Calculation Linkbase Document  |
| 101.LAB*** | XBRL Taxonomy Extension Label Linkbase Document        |
| 101.PRE*** | XBRL Taxonomy Extension Presentation Linkbase Document |
| 101.DEF*** | XBRL Definition Linkbase                               |

\*\*\* Attached as Exhibit 101 to this Quarterly Report on Form 10-Q are the following materials, formatted in XBRL (eXtensible Business Reporting Language): (i) the Condensed Consolidated Balance Sheets as of March 31, 2015 and December 31, 2014, (ii) the Condensed Consolidated Statements of Operations for the three months ended March 31, 2015 and 2014, (iii) the Condensed Consolidated Statements of Cash Flows for the three months ended March 31, 2015 and 2014 and (iv) the Notes to Condensed Consolidated Financial Statements.

**Table of Contents**

**SIGNATURES**

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

**Gladstone Commercial Corporation**

Date: May 4, 2015

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

Date: May 4, 2015

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