

GLADSTONE COMMERCIAL CORP  
Form 10-Q  
November 05, 2008

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549  
FORM 10-Q**

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934  
FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2008  
OR**

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934  
COMMISSION FILE NUMBER: 0-50363  
GLADSTONE COMMERCIAL CORPORATION  
(Exact name of registrant as specified in its charter)**

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

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

**1521 WESTBRANCH DRIVE, SUITE 200  
MCLEAN, VIRGINIA 22102  
(Address of principal executive office)  
(703) 287-5800**

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days. Yes  No . Indicate by check mark whether the registrant 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  Smaller reporting company   
(Do not check if a 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 October 31, 2008 was 8,565,264.

GLADSTONE COMMERCIAL CORPORATION  
TABLE OF CONTENTS

	PAGE
<b>PART I FINANCIAL INFORMATION</b>	
Item 1. Financial Statements (Unaudited)	
Consolidated Balance Sheets as of September 30, 2008 and December 31, 2007	3
Consolidated Statements of Operations for the three and nine months ended September 30, 2008 and 2007	4
Consolidated Statements of Cash Flows for the nine months ended September 30, 2008 and 2007	5
Notes to Consolidated Financial Statements	6
Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations	22
Item 3. Quantitative and Qualitative Disclosures about Market Risk	33
Item 4. Controls and Procedures	34
<b>PART II OTHER INFORMATION</b>	
Item 1. Legal Proceeding	35
Item 1A. Risk Factors	35
Item 2. Unregistered Sales of Equity Securities and Use of Proceeds	36
Item 3. Defaults Upon Senior Securities	36
Item 4. Submission of Matters to a Vote of Security Holders	36
Item 5. Other Information	36
Item 6. Exhibits	36
SIGNATURES	38

**GLADSTONE COMMERCIAL CORPORATION**  
**CONSOLIDATED BALANCE SHEETS**  
(Unaudited)

	September 30, 2008	December 31, 2007
<b>ASSETS</b>		
Real estate, net	\$ 367,715,344	\$ 324,761,772
Lease intangibles, net	32,467,191	28,989,556
Mortgage notes receivable	10,000,000	10,000,000
Cash and cash equivalents	3,064,675	1,356,408
Restricted cash	2,637,531	1,914,067
Funds held in escrow	1,988,558	1,401,695
Deferred rent receivable	6,667,829	5,094,799
Deferred financing costs, net	4,752,282	4,405,129
Prepaid expenses and other assets	989,645	979,263
<b>TOTAL ASSETS</b>	<b>\$ 430,283,055</b>	<b>\$ 378,902,689</b>
 <b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
<b>LIABILITIES</b>		
Mortgage notes payable	\$ 255,425,225	\$ 202,120,471
Short-term loan and borrowings under line of credit	30,200,000	24,400,000
Deferred rent liability	3,343,863	3,933,035
Asset retirement obligation liability	2,155,341	1,811,752
Accounts payable and accrued expenses	514,222	778,949
Due to adviser (Refer to Note 2)	1,231,722	784,301
Obligation under capital lease	232,301	
Rent received in advance, security deposits and funds held in escrow	3,600,768	2,706,113
<b>Total Liabilities</b>	<b>296,703,442</b>	<b>236,534,621</b>
 <b>STOCKHOLDERS EQUITY</b>		
Redeemable preferred stock, \$0.001 par value; \$25 liquidation preference; 2,300,000 shares authorized and 2,150,000 shares issued and outstanding	2,150	2,150
Common stock, \$0.001 par value, 47,700,000 shares authorized and 8,565,264 shares issued and outstanding	8,565	8,565
Additional paid in capital	170,640,979	170,640,979
Notes receivable employees	(2,629,846)	(2,769,923)
Distributions in excess of accumulated earnings	(34,442,235)	(25,513,703)

Total Stockholders Equity	133,579,613	142,368,068
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	\$ 430,283,055	\$ 378,902,689

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

3

---

**GLADSTONE COMMERCIAL CORPORATION**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**  
**(Unaudited)**

	For the three months ended September 30,		For the nine months ended September 30,	
	2008	2007	2008	2007
Operating revenues				
Rental income	\$ 10,157,553	\$ 8,024,305	\$ 29,269,036	\$ 22,834,663
Interest income from mortgage notes receivable	216,446	255,555	673,548	758,333
Tenant recovery revenue	83,144	80,648	253,495	230,851
<b>Total operating revenues</b>	<b>10,457,143</b>	<b>8,360,508</b>	<b>30,196,079</b>	<b>23,823,847</b>
Operating expenses				
Depreciation and amortization	3,262,903	2,668,383	9,435,690	7,722,349
Property operating expenses	225,020	204,972	670,442	597,273
Base management fee (Refer to Note 2)	404,108	459,202	1,255,833	1,412,337
Incentive fee (Refer to Note 2)	793,787	677,104	2,300,286	1,896,677
Administration fee (Refer to Note 2)	238,241	175,852	724,978	592,996
Professional fees	117,857	118,371	362,584	442,479
Insurance	43,354	53,943	126,947	171,275
Directors fees	54,702	66,250	161,202	174,750
Stockholder related expenses	42,232	40,991	271,430	215,969
Asset retirement obligation expense	35,157	29,440	98,394	86,542
General and administrative	105,999	17,452	139,151	79,119
<b>Total operating expenses before credit from Adviser</b>	<b>5,323,360</b>	<b>4,511,960</b>	<b>15,546,937</b>	<b>13,391,766</b>
Credit to incentive fee (Refer to Note 2)	(205,876)	(526,991)	(941,928)	(1,746,564)
<b>Total operating expenses</b>	<b>5,117,484</b>	<b>3,984,969</b>	<b>14,605,009</b>	<b>11,645,202</b>
Other income (expense)				
Interest income from temporary investments	4,559	33,105	20,796	325,390
Interest income employee loans	49,624	52,728	152,620	169,608
Other income	7,500	9,896	56,493	28,127
Interest expense	(4,258,461)	(2,920,270)	(12,008,316)	(8,137,343)
<b>Total other expense</b>	<b>(4,196,778)</b>	<b>(2,824,541)</b>	<b>(11,778,407)</b>	<b>(7,614,218)</b>

Edgar Filing: GLADSTONE COMMERCIAL CORP - Form 10-Q

Income from continuing operations	1,142,881	1,550,998	3,812,663	4,564,427
Discontinued operations				
(Loss) income from discontinued operations	(1,322)	5,975	(34,956)	471
Net realized income from foreign currency transactions		33,487		33,550
Taxes refunded on sale of real estate				78,667
Total discontinued operations	(1,322)	39,462	(34,956)	112,688
Net income	1,141,559	1,590,460	3,777,707	4,677,115
Dividends attributable to preferred stock	(1,023,437)	(1,023,438)	(3,070,312)	(3,070,312)
Net income available to common stockholders	\$ 118,122	\$ 567,022	\$ 707,395	\$ 1,606,803
Earnings per weighted average common share basic & diluted				
Income from continuing operations (net of dividends attributable to preferred stock)	\$ 0.01	\$ 0.07	\$ 0.08	\$ 0.18
Discontinued operations	0.00	0.00	0.00	0.01
Net income available to common stockholders	\$ 0.01	\$ 0.07	\$ 0.08	\$ 0.19
Weighted average shares outstanding- basic & diluted	8,565,264	8,565,264	8,565,264	8,565,264

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

**GLADSTONE COMMERCIAL CORPORATION**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**(Unaudited)**

	For the nine months ended September	
	2008	2007
	30,	
<b>Cash flows from operating activities:</b>		
Net income	\$ 3,777,707	\$ 4,677,115
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	9,435,690	7,722,349
Amortization of deferred financing costs	806,075	509,990
Amortization of deferred rent asset and liability, net	(399,049)	(399,051)
Accretion of obligation under capital lease	7,234	
Asset retirement obligation expense	98,394	86,542
Decrease (increase) in prepaid expenses	(110,382)	28,815
Increase in deferred rent receivable	(1,763,153)	(1,247,345)
Increase in accounts payable, accrued expenses, and amount due adviser	182,694	516,996
Increase in rent received in advance	171,191	137,534
Net cash provided by operating activities	12,206,401	12,032,945
<b>Cash flows from investing activities:</b>		
Real estate investments	(48,935,032)	(85,742,539)
Receipts from lenders for reserves held in escrow	630,033	1,007,684
Payments to lenders for reserves held in escrow	(1,216,896)	(1,010,385)
Increase in restricted cash	(723,464)	(275,696)
Deposits on future acquisitions	(1,650,000)	(1,310,000)
Deposits applied against real estate investments	1,750,000	1,610,000
Net cash used in investing activities	(50,145,359)	(85,720,936)
<b>Cash flows from financing activities:</b>		
Borrowings under mortgage notes payable	48,015,000	32,521,691
Principal repayments on mortgage notes payable	(1,171,849)	(599,328)
Principal repayments on employee notes receivable from sale of common stock	140,077	400,598
Borrowings from line of credit	62,600,000	24,200,000
Repayments on line of credit	(56,800,000)	(4,200,000)
Receipts from tenants from reserves	1,746,804	1,446,577
Payments to tenants from reserves	(1,555,146)	(1,311,406)
Increase in security deposits	531,806	140,525
Payments for deferred financing costs	(1,153,228)	(770,761)
Dividends paid for common and preferred	(12,706,239)	(12,320,797)
Net cash provided by financing activities	39,647,225	39,507,099

Net increase (decrease) in cash and cash equivalents	1,708,267	(34,180,892)
Cash and cash equivalents, beginning of period	1,356,408	36,005,686
Cash and cash equivalents, end of period	\$ 3,064,675	\$ 1,824,794

**NON-CASH OPERATING, INVESTING AND FINANCING INFORMATION**

Additions to real estate included in accounts payable, accrued expenses, and amount due adviser	\$	\$ 409,000
Increase in asset retirement obligation	\$ 245,195	\$ 150,523
Fixed rate debt assumed in connection with acquisitions	\$ 6,461,603	\$ 4,506,689

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



**GLADSTONE COMMERCIAL CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**1. Organization and Significant Accounting Policies**

Gladstone Commercial Corporation (the *Company*) is a Maryland corporation that operates in a manner so as to qualify as a real estate investment trust ( *REIT* ) for federal income tax purposes and was incorporated on February 14, 2003 under the General Corporation Law of Maryland, primarily for the purpose of engaging in the business of investing in real estate properties net leased to creditworthy entities and making mortgage loans to creditworthy entities. Subject to certain restrictions and limitations, the business of the *Company* is managed by Gladstone Management Corporation, a Delaware corporation (the *Adviser* ).

***Subsidiaries***

The *Company* conducts substantially all of its operations through a subsidiary, Gladstone Commercial Limited Partnership, a Delaware limited partnership, (the *Operating Partnership* ). As the *Company* currently owns all of the general and limited partnership interests of the *Operating Partnership* through GCLP Business Trust I and II as disclosed below, the financial position and results of operations of the *Operating Partnership* are consolidated with those of the *Company*.

Gladstone Commercial Partners, LLC, a Delaware limited liability company ( *Commercial Partners* ) and a subsidiary of the *Company*, was organized to engage in any lawful act or activity for which a limited liability company may be organized in Delaware. *Commercial Partners* has the power to make and perform all contracts and to engage in all activities to carry out the purposes of the *Company*, and all other powers available to it as a limited liability company. As the *Company* currently owns all of the membership interests of *Commercial Partners*, the financial position and results of operations of *Commercial Partners* are consolidated with those of the *Company*.

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

Gladstone Commercial Advisers, Inc., a Delaware corporation ( *Commercial Advisers* ) and a subsidiary of the *Company*, is a taxable REIT subsidiary ( *TRS* ), which was created to collect all non-qualifying income related to the *Company*'s real estate portfolio. It is currently anticipated that this income will predominately consist of fees received by the *Company* related to the leasing of real estate. There have been no such fees earned to date. Since the *Company* owns 100% of the voting securities of *Commercial Advisers*, the financial position and results of operations of *Commercial Advisers* are consolidated with those of the *Company*.

GCLP Business Trust I and GCLP Business Trust II, subsidiaries of the *Company*, each are business trusts formed under the laws of the Commonwealth of Massachusetts on December 28, 2005. The *Company* transferred its 99% limited partnership interest in the *Operating Partnership* to GCLP Business Trust I in exchange for 100 trust shares. *Commercial Partners* transferred its 1% general partnership interest in the *Operating Partnership* to GCLP Business Trust II in exchange for 100 trust shares.

***Interim financial information***

Interim financial statements of the Company are prepared in accordance with accounting principles generally accepted in the United States of America ( GAAP ) for interim financial information and pursuant to the requirements for reporting on Form 10-Q and Article 10 of Regulation S-X. Accordingly, certain disclosures accompanying annual financial statements prepared in accordance with GAAP are omitted. In the opinion of management, all adjustments, consisting solely of normal recurring accruals, necessary for the fair statement of financial statements for the interim period have been included.

***Investments in real estate***

The Company records investments in real estate at cost and capitalizes improvements and replacements when they extend the useful life or improve the efficiency of the asset. The Company expenses costs of repairs and maintenance as incurred. The Company computes depreciation using the straight-line method over the estimated useful life of 39 years for buildings and improvements, five to seven years for equipment and fixtures and the shorter of the useful life or the remaining lease term for tenant improvements and leasehold interests.

The Company accounts for its acquisitions of real estate in accordance with Statement of Financial Accounting Standards ( SFAS ) No. 141, Business Combinations, which requires the purchase price of real estate to be allocated to the acquired tangible assets and liabilities, consisting of land, building, tenant improvements, long-term debt and identified intangible assets and liabilities, consisting of the value of above-market and below-market leases, the value of in-place leases, the value of unamortized lease origination costs, the value of tenant relationships and the value of capital lease obligations, based in each case on their fair values.

Management's estimates of value are made using methods similar to those used by independent appraisers (e.g., discounted cash flow analysis). Factors considered by management in its analysis include an estimate of carrying costs during hypothetical expected lease-up periods considering current market conditions, and costs to execute similar leases. The Company also considers information obtained about each property as a result of its 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 expected lease-up periods, which primarily range from nine to eighteen months, depending on specific local market conditions. Management also estimates costs to execute similar leases, including leasing commissions, legal and other related expenses to the extent that such costs are not already incurred in connection with a new lease origination as part of the transaction.

The Company allocates purchase price to the fair value of the tangible assets of an acquired property by valuing the property as if it were vacant. The as-if-vacant value is allocated to land, building, and tenant improvements based on management's determination of the relative fair values of these assets. Real estate depreciation expense on these tangible assets was approximately \$2.3 million and \$6.7 million for the three and nine months ended September 30, 2008, respectively, and approximately \$1.8 million and \$5.2 million for the three and nine months ended September 30, 2007, respectively.

Above-market and below-market in-place lease values for owned properties are recorded based on the present value (using an interest rate which reflects the risks associated with the leases acquired) of the difference between (i) the contractual amounts to be paid pursuant to the in-place leases and (ii) 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. The capitalized above-market lease values, included in the accompanying balance sheet as part of deferred rent receivable, are amortized as a reduction of rental income over the remaining non-cancelable terms of the respective leases. Total amortization related to above-market lease values was \$63,374 and \$190,123 for the three and nine months ended September 30, 2008 and 2007, respectively. The capitalized below-market lease values, included in the accompanying balance sheet as deferred rent liability, are amortized as an increase to rental income over the remaining non-cancelable terms of the respective leases. Total amortization related to below-market lease values was \$196,391 and \$589,173 for the three and nine months ended September 30, 2008 and 2007, respectively.

The total amount of the remaining intangible assets acquired, which consist 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 the Company's overall relationship with that respective tenant. Characteristics to be considered by management in allocating 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 expectations of lease renewals (including those existing under the terms of the lease agreement), among other factors.

The value of in-place leases and unamortized lease origination costs are amortized to expense over the remaining term of the respective leases, which generally range from 10 to 15 years. The value of customer relationship intangibles, which is the benefit to the Company resulting from the likelihood of an existing tenant renewing its lease, are amortized to expense over the remaining term and any anticipated renewal periods in the respective leases, but in no event does the amortization period for intangible assets exceed the remaining depreciable life of the building. Should a tenant terminate its lease, the unamortized portion of the above-market and below-market lease values, in-place lease values, unamortized lease origination costs and customer relationship intangibles will be charged to expense. Total amortization expense related to these intangible assets was approximately \$0.9 million and \$2.8 million for the three and nine months ended September 30, 2008, respectively, and approximately \$0.8 million and \$2.5 million for the three and nine months ended September 30, 2007, respectively.

### ***Impairment***

#### ***Investments in Real Estate***

The Company accounts for the impairment of real estate in accordance with SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, which requires that the Company 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. If circumstances support the possibility of impairment, the Company prepares a projection of the undiscounted future cash flows, without interest charges, of the specific property and determines if the investment in such property is recoverable. If impairment is indicated, the carrying value of the property would be written down to its estimated fair value based on the Company's best estimate of the property's discounted future cash flows. There have been no impairments recognized on real estate assets in the Company's history.

#### ***Provision for Loan Losses***

The Company's accounting policies require that it reflect in its financial statements an allowance for estimated credit losses with respect to mortgage loans it has made based upon its evaluation of known and inherent risks associated with its private lending assets. Management reflects provisions for loan losses based upon its assessment of general market conditions, its internal risk management policies and credit risk rating system, industry loss experience, its assessment of the likelihood of delinquencies or defaults, and the value of the collateral underlying its investments. Actual losses, if any, could ultimately differ from these estimates. There have been no provisions for loan losses in the Company's history.

#### ***Cash and cash equivalents***

The Company considers all short-term, highly liquid investments that are both readily convertible to cash and have a maturity of three months or less at the time of purchase to be cash equivalents; except that any such investments purchased with funds held in escrow or similar accounts are classified as restricted cash. Items classified as cash equivalents include money-market deposit accounts. All of the Company's cash and cash equivalents at September 30, 2008 were held in the custody of one financial institution, and the Company's balance at times may exceed federally insurable limits. The Company mitigates this risk by depositing funds with major financial institutions.

***Restricted cash***

Restricted cash consists of security deposits and funds held in escrow for certain tenants. The funds held in escrow are for capital improvements, taxes, insurance and other replacement reserves for certain of our tenants. These funds will be released to the tenants upon completion of agreed upon tasks as specified in the lease agreements, mainly consisting of maintenance and repairs on the buildings, and when evidence of insurance and tax payments has been submitted to the Company.

***Funds held in escrow***

Funds held in escrow consist of funds held by certain of the Company's lenders for properties held as collateral by these lenders. These funds consist of replacement reserves for capital improvements, repairs and maintenance, insurance and taxes. These funds will be released to the Company upon completion of agreed upon tasks as specified in the mortgage agreements, mainly consisting of maintenance and repairs on the buildings, and when evidence of insurance and tax payments has been submitted to the lenders.

***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 financing secured. The Company made payments of \$1,096,766 and \$1,153,228 for deferred financing costs during the three and nine months ended September 30, 2008, respectively, and \$82,736 and \$770,761 for the three and nine months ended September 30, 2007, respectively. Total amortization expense related to deferred financing costs was \$300,318 and \$806,075 for the three and nine months ended September 30, 2008, respectively, and \$176,817 and \$509,990 for the three and nine months ended September 30, 2007, respectively. Accumulated amortization was \$2,990,567 and \$2,184,492 as of September 30, 2008 and December 31, 2007, respectively.

***Prepaid expenses and other assets***

Prepaid expenses and other assets consist of accounts receivable, interest receivable, prepaid assets and deposits on real estate.

***Obligation under capital lease***

In conjunction with the Company's acquisition of a building in Fridley, Minnesota on February 26, 2008, it was assigned a ground lease on the parking lot of the building at the time of closing, which had a purchase obligation to acquire the land under the ground lease at the end of the term, April 1, 2014. In accordance with SFAS No. 13

Accounting for Leases, the Company accounted for the ground lease as a capital lease and recorded the corresponding obligation under the capital lease.

***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. Certain of the Company's leases currently contain rental increases at specified intervals. We recognize such revenues on a straight-line basis by averaging the non-cancelable rental revenues over the lease terms. Deferred rent receivable in the accompanying 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 lease values of certain acquired properties. Accordingly, the Company determines, in its judgment, to what extent the deferred rent receivable applicable to each specific tenant is collectible. The Company reviews deferred rent receivable, as it relates to straight line rents, on a quarterly basis and takes 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 area in which the property is located. In the event that the collectibility of deferred rent with respect to any given tenant is in doubt, the Company records an increase in the allowance for uncollectible accounts or records a direct write-off of the specific rent receivable, which would have an adverse effect on the net income for the year in which the reserve is increased or the direct write-off is recorded and would decrease total assets and stockholders' equity. No such reserves have been recorded as of September 30, 2008.

Management considers its loans and other lending investments to be held-for-investment. The Company reflects held-for-investment investments at amortized cost, less allowance for loan losses, acquisition premiums or discounts, and deferred loan fees. On occasion, the Company may acquire loans at small premiums or discounts based on the credit characteristics of such loans. These premiums or discounts are 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, the Company immediately recognizes 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.

Certain of the Company's mortgage loans and leases have embedded derivatives in the form of interest rate floors and ceilings. These embedded derivatives do not require separate accounting under SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities.

#### ***Income taxes***

The Company has operated and intends to continue to operate in a manner that will allow it to qualify as a REIT under the Internal Revenue Code of 1986, as amended, and accordingly will not be subject to federal income taxes on amounts distributed to stockholders (except income from foreclosure property), provided it distributes at least 90% of its REIT taxable income to its stockholders and meets certain other conditions. To the extent that the Company satisfies the distribution requirement but distributes less than 100% of its taxable income, the Company will be subject to federal corporate income tax on its undistributed income.

Commercial Advisers is a wholly-owned TRS that is subject to federal and state income taxes. Though Commercial Advisers has had no activity to date, the Company would account for any future income taxes in accordance with the provisions of SFAS No. 109, Accounting for Income Taxes. Under SFAS No. 109, the Company accounts for income taxes using the asset and liability method under which deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases.

#### ***Segment information***

SFAS No. 131, Disclosures about Segments of an Enterprise and Related Information, provides standards for public companies relating to the reporting of financial and descriptive information about their operating segments in financial statements. Operating segments are defined as components of an enterprise for which separate financial information is available and is evaluated regularly by the chief operating decision maker or decision making group in determining how to allocate resources and in assessing performance. Company management is the chief decision making group. As discussed in Note 9, the Company's operations are derived from two operating segments, one segment purchases real estate (land, buildings and other improvements), which is simultaneously leased to existing users, and the other segment originates mortgage loans and collects principal and interest payments.

#### ***Foreign currency transactions***

The Company purchased two properties in Canada in October 2004. These properties were classified as held for sale as of June 30, 2006, and were sold in July 2006. All gains and losses from foreign currency transactions are reflected in discontinued operations in the Company's consolidated financial statements. The Company had a bank account in Canada, which was closed in December 2007. The cash account was re-valued at each balance sheet date to reflect the then current exchange rate. The gains or losses from the valuation of the cash were recorded on the income statement as a realized gain or loss. Realized foreign currency gains of \$33,487 and \$33,550 were recorded for the three and nine months ended September 30, 2007, respectively. There were no realized foreign currency gains or losses recorded for the three and nine months ended September 30, 2008 since the account was closed in December 2007.

***Asset retirement obligations***

In March 2005, the Financial Accounting Standards Board ( FASB ) issued Interpretation No. 47, Accounting for Conditional Asset Retirement Obligations ( FIN 47 ). FIN 47 requires an entity to recognize a liability for a conditional asset retirement obligation when incurred if the liability can be reasonably estimated. FIN 47 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. FIN 47 also clarifies when an entity would have sufficient information to reasonably estimate the fair value of an asset retirement obligation. The Company has accrued a liability and corresponding increase to the cost of the related properties for disposal related to all properties constructed prior to 1985 that have, or may have, asbestos present in the building. The Company accrued a liability during the nine months ended September 30, 2008 of \$245,195 related to properties acquired during the period. The Company also recorded expense of \$35,157 and \$98,394 for the three and nine months ended September 30, 2008, respectively, and \$29,440 and \$86,542 for the three and nine months ended September 30, 2007, respectively, related to the cumulative accretion of the obligation.

***Real estate held for sale and discontinued operations***

SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, requires that the results of operations of any properties which have been sold, or are held for sale, be presented as discontinued operations in the Company s consolidated financial statements in both current and prior periods presented. Income items related to held for sale properties are listed separately on the Company s consolidated income statement. 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 the Company s consolidated balance sheet. Once properties are listed as held for sale, no further depreciation is recorded.

***Recently Issued Accounting Pronouncements***

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements ( SFAS 157 ). SFAS 157 defines fair value, establishes a framework for measuring fair value in GAAP and expands disclosures about fair value measurements. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company has only partially adopted the provisions of SFAS 157 because of the issuance of FSP SFAS 157-2 (the FSP ), which allows companies to delay the effective date of SFAS 157 for non-financial assets and liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis. The partial adoption had no impact on the Company s results of operations. In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities ( SFAS 159 ). SFAS 159 allows entities to measure at fair value many financial instruments and certain other assets and liabilities that are not otherwise required to be measured at fair value. SFAS 159 is effective for fiscal years beginning after November 15, 2007. The Company adopted SFAS 159 effective for the fiscal year beginning January 1, 2008, and the adoption had no impact on the Company s results of operations.

In December 2007, the FASB issued SFAS No. 141 (revised 2007), Business Combinations, SFAS No. 141(R), which replaces SFAS No. 141, Business Combinations ( SFAS 141R ). SFAS 141R significantly changes the accounting for acquisitions involving business combinations, as it requires that the assets and liabilities of all business combinations be recorded at fair value, with limited exceptions. SFAS 141R also requires that all expenses related to the acquisition be expensed as incurred, rather than capitalized into the cost of the acquisition as had been the previous accounting under SFAS No. 141. SFAS 141R is effective on a prospective basis for all business combinations for which the acquisition date is on or after the beginning of the first annual period subsequent to December 15, 2008. If SFAS 141R had been in effect as of January 1, 2008, the Company would have expensed approximately \$0.73 million of transaction costs related to the six acquisitions completed during the nine months ended September 30, 2008, or approximately 1.4% of the total purchase price of the acquired properties, which would have resulted in a decrease in funds from operations ( FFO ) of approximately 7.2%. The impact on the Company s results of operations could differ significantly when the pronouncement is adopted on January 1, 2009.

In December 2007, the FASB issued SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements ( SFAS 160 ). SFAS 160 requires all entities to report noncontrolling (minority) interests in subsidiaries in the same way as equity in the consolidated financial statements. SFAS 160 is effective for fiscal years beginning after December 15, 2008. The Company does not believe the adoption of this pronouncement will have a material impact on its results of operations.

In March 2008, the FASB issued SFAS No. 161, Disclosures about Derivative Instruments and Hedging Activities ( SFAS 161 ), which is intended to help investors better understand how derivative instruments and hedging activities affect an entity's financial position, financial performance and cash flows through enhanced disclosure requirements. The enhanced disclosures primarily surround disclosing the objectives and strategies for using derivative instruments by their underlying risk as well as a tabular format of the fair values of the derivative instruments and their gains and losses. SFAS 161 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008.

In April 2008, the FASB issued FASB Staff Position No. 142-3, Determination of the Useful Life of Intangible Assets ( FSP SFAS 142-3 ), which amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under FASB Statement No. 142

Goodwill and Other Intangible Assets ( SFAS 142 ). FSP SFAS 142-3 is intended to improve the consistency between the useful life of a recognized intangible asset under SFAS 142 and the period of expected cash flows used to measure the fair value of the asset under SFAS 141R. FSP SFAS No. 142-3 is effective for financial statements issued for fiscal years beginning after December 15, 2008, as well as interim periods within those fiscal years, and must be applied prospectively to intangible assets acquired after the effective date. The Company is currently evaluating the impact the adoption of the pronouncement will have on its results of operations.

***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 period. Actual results could materially differ from those estimates.

***Reclassifications***

Certain amounts from prior years' financial statements have been reclassified to conform to the current presentation. These reclassifications had no effect on previously reported net income or stockholders' equity.

## 2. Management Advisory Fee

The Company has been externally managed pursuant to a contractual investment advisory arrangement with its Adviser, under which its Adviser has directly employed all of the Company's personnel and paid its payroll, benefits, and general expenses directly. The Company's initial investment advisory agreement with its Adviser was in place from August 12, 2003 through December 31, 2006 (the Initial Advisory Agreement). On January 1, 2007, the Company entered into an amended and restated investment advisory agreement with its Adviser (the Amended Advisory Agreement) and an administration agreement (the Administration Agreement) with a wholly-owned subsidiary of the Adviser, Gladstone Administration, LLC (the Administrator). The management services and fees in effect under the Amended Advisory and Administration Agreements are described below.

### *Amended Advisory Agreement*

The Amended Advisory Agreement provides for an annual base management fee equal to 2% of the Company's total stockholders' equity, less the recorded value of any preferred stock, and an incentive fee based on FFO. For the three and nine months ended September 30, 2008, the Company recorded a base management fee of \$404,108 and \$1,255,833, respectively, and for the three and nine months ended September 30, 2007, the Company recorded a base management fee of \$459,202 and \$1,412,337, respectively. For purposes of calculating the incentive fee, FFO includes any realized capital gains and capital losses, less any dividends paid on preferred stock, but FFO does not include any unrealized capital gains or losses. The incentive fee rewards the Adviser if the Company's quarterly FFO, before giving effect to any incentive fee (pre-incentive fee FFO), exceeds 1.75%, or 7% annualized, (the hurdle rate) of total stockholders' equity, less the recorded value of any preferred stock. 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 the Company's pre-incentive fee FFO. The Adviser also receives an incentive fee of 20% of the amount of the Company's pre-incentive fee FFO that exceeds 2.1875%.

For the three and nine months ended September 30, 2008, the Company recorded an incentive fee of \$793,787 and \$2,300,286, respectively, offset by a credit related to an unconditional and irrevocable voluntary waiver issued by the Adviser of \$205,876 and \$941,928, respectively, for a net incentive fee for the three and nine months ended September 30, 2008 of \$587,911 and \$1,358,358, respectively. For the three and nine months ended September 30, 2007, the Company recorded an incentive fee of \$677,104 and \$1,896,677, respectively, offset by a credit related to an unconditional and irrevocable voluntary waiver issued by the Adviser of \$526,991 and \$1,746,564, respectively, for a net incentive fee for the three and nine months ended September 30, 2007 of \$150,113. The board of directors of the Company accepted the Adviser's offer to unconditionally, irrevocably and voluntarily waive a portion of the incentive fee for the three and nine months ended September 30, 2008 and 2007, in order to maintain the current level of distributions to the Company's stockholders.

### *Administration Agreement*

Under the Administration Agreement, the Company pays separately for its allocable portion of the Administrator's overhead expenses in performing its obligations including, but not limited to, rent for employees of the Administrator, and its allocable portion of the salaries and benefits expenses of its chief financial officer, chief compliance officer, controller, treasurer and their respective staffs. The Company's allocable portion of expenses is derived by multiplying the Administrator's total allocable expenses by the percentage of the Company's average total assets (the total assets at the beginning and end of each quarter) in comparison to the average total assets of all companies managed by the Adviser under similar agreements. For the three and nine months ended September 30, 2008, the Company recorded an administration fee of \$238,241 and \$724,978, respectively, and for the three and nine months ended September 30, 2007, the Company recorded an administration fee of \$175,852 and \$592,996, respectively.



**3. Earnings per Common Share**

The following tables set forth the computation of basic and diluted earnings per share for the three and nine months ended September 30, 2008 and 2007:

	For the three months ended September 30,		For the nine months ended September 30,	
	2008	2007	2008	2007
Net income available to common stockholders	\$ 118,122	\$ 567,022	\$ 707,395	\$ 1,606,803
Denominator for basic & diluted weighted average shares	8,565,264	8,565,264	8,565,264	8,565,264
Basic & diluted earnings per common share	\$ 0.01	\$ 0.07	\$ 0.08	\$ 0.19

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

The following table sets forth the components of the Company's investments in real estate, including capitalized leases, as of September 30, 2008 and December 31, 2007:

	September 30, 2008	December 31, 2007
Real estate:		
Land	\$ 55,226,042 (1)	\$ 48,867,482
Building	325,090,570	283,829,987
Tenant improvements	9,820,706	7,802,937
Accumulated depreciation	(22,421,974)	(15,738,634)
Real estate, net	\$ 367,715,344	\$ 324,761,772

(1) Includes land held under a capital lease carried at approximately \$1.1 million.

During the nine months ended September 30, 2008, the Company acquired six properties, which are summarized below:

(1)

On January 29, 2008, the Company acquired a 42,900 square foot industrial building in Reading, Pennsylvania for approximately \$7.2 million, including transaction costs. At closing, the Company extended a 20 year triple net lease with the sole tenant, and the tenant has four options to extend the lease for additional periods of five years each. The lease provides for prescribed rent escalations over the life of the lease, with annualized straight line rents of approximately \$0.72 million.

- (2) On February 26, 2008, the Company acquired a 74,160 square foot office building in Fridley, Minnesota for approximately \$10.6 million, including

transaction costs. At closing, the Company was assigned the previously existing triple net lease with the sole tenant, which had a remaining term of approximately five years. The tenant has two options to extend the lease for additional periods of five years each. The lease provides for prescribed rent escalations over the life of the lease, with annualized straight line rents of approximately \$0.95 million. The Company was also assigned a ground lease on the parking lot at the time of closing, which has a remaining term of approximately six years. At the end of the term, the Company is required to purchase the land. The rent due under the ground lease had been prepaid by the previous owner

through the end  
of the term.

- (3) On March 31, 2008, the Company acquired a 273,300 square foot industrial building in Concord Township, Ohio for approximately \$15.3 million, including transaction costs. At closing, the Company extended a 20 year triple net lease with the sole tenant, and the tenant has three options to extend the lease for additional periods of five years each. The lease provides for prescribed rent escalations over the life of the lease, with annualized straight line rents of approximately \$1.72 million.

- (4) On April 30, 2008, the Company acquired a 74,950 square foot industrial building in Pineville, North Carolina for approximately \$3.9 million, including transaction costs. At closing, the Company extended a 20 year triple net lease with the sole tenant, and the tenant has three options to extend the lease for additional periods of five years each. The lease provides for prescribed rent escalations over the life of the lease, with annualized straight line rents of approximately \$0.43 million.
- (5) On August 29, 2008, the Company acquired a 223,458 square foot industrial building in Marietta, Ohio for approximately \$8.1 million,

including transaction costs. At closing, the Company extended a 20 year triple net lease with the sole tenant, and the tenant has two options to extend the lease for additional periods of ten years each. The lease provides for prescribed rent escalations over the life of the lease, with annualized straight line rents of approximately \$0.90 million.

- (6) On August 29, 2008, the Company acquired a 67,200 square foot office building in Chalfont, Pennsylvania for approximately \$8.4 million, including transaction costs, which was funded by a combination of cash on hand, and the assumption of approximately \$6.5 million of financing on the property. At

closing, the Company was assigned the previously existing triple net lease with the sole tenant, which had a remaining term of approximately 7 years. The tenant has two options to extend the lease for additional periods of five years each. The lease provides for prescribed rent escalations over the life of the lease, with annualized straight line rents of approximately \$0.76 million.

In accordance with SFAS No. 141, Business Combinations, the Company allocated the purchase price of the properties acquired during the nine months ended September 30, 2008 as follows:

	Land	Building	Tenant Improvements	In-place Leases	Leasing Costs	Customer Relationships	Obligations	Total Purchase Price
Reading, Pennsylvania	\$ 490,646	\$ 6,188,168	\$ 14,208	\$ 362,479	\$ 1,786	\$ 141,232	\$	\$ 7,198,519
Fridley, Minnesota	1,354,233	7,454,098	619,428	452,414	171,005	807,950	(225,067)	10,634,061
Concord Township, Ohio	1,796,467	10,254,003	900,120	1,702,792	5,102	917,661	(245,198)	15,330,947
Pineville, North Carolina	669,025	2,930,295	98,025	151,426	2,218	93,080		3,944,069
Marietta, Ohio	829,014	6,537,796	69,469	479,124	3,268	179,014		8,097,685
Chalfont, Pennsylvania	1,249,415	6,105,819	316,519	172,278	189,326	397,841		8,431,198
	\$ 6,388,800	\$ 39,470,179	\$ 2,017,769	\$ 3,320,513	\$ 372,705	\$ 2,536,778	\$ (470,265)	\$ 53,636,479

*Intangible Assets*

The weighted average amortization period for the intangible assets acquired during the nine months ended September 30, 2008, were as follows:

	Years
Intangible assets	
In-place leases	16.8
Leasing costs	18.2
Customer relationships	22.7
All intangible assets	16.7

There were no allocations to above or below market lease intangibles for the six acquisitions during the nine months ended September 30, 2008.



Future operating lease payments from tenants under non-cancelable leases, excluding tenant reimbursement of expenses, in effect at September 30, 2008, were as follows:

	Tenant Lease Payments
Three months ending December 31, 2008	\$ 9,922,367
Year ending December 31, 2009	38,749,365
2010	38,743,925
2011	38,352,963
2012	38,056,061
2013	32,691,790
Thereafter	184,282,955

In accordance with the lease terms, substantially all tenant expenses are required to be paid by the tenant; however, the Company would be required to pay property taxes on the respective properties, and ground lease payments on the property located in Tulsa, Oklahoma, in the event the tenant fails to pay them. The total annualized property taxes for all properties held by the Company at September 30, 2008 was approximately \$5.5 million, and the total annual ground lease payments on the Tulsa, Oklahoma property was approximately \$134,000.

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

	September 30, 2008		December 31, 2007	
	Lease Intangibles	Accumulated Amortization	Lease Intangibles	Accumulated Amortization
In-place leases	\$ 15,981,245	\$ (4,661,864)	\$ 12,660,732	\$ (3,414,868)
Leasing costs	9,662,731	(2,769,660)	9,290,026	(2,114,233)
Customer relationships	17,136,501	(2,881,762)	14,599,726	(2,031,827)
	\$ 42,780,477	\$ (10,313,286)	\$ 36,550,484	\$ (7,560,928)

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

	Estimated Aggregate Amortization Expense
Three months ending December 31, 2008	\$ 688,090
Year ending December 31, 2009	2,687,299
2010	2,623,713
2011	2,480,618
2012	2,190,906
2013	1,312,252
Thereafter	6,319,267

## 5. Discontinued Operations

On July 21, 2006, the Company sold its two Canadian properties for approximately \$6.9 million, for a gain on the sale of approximately \$1.4 million. The Company incurred approximately \$315,000 in taxes related to the gain on the sale in 2006. The 2006 tax returns were subsequently filed in March of 2007, and the amount owed was approximately

\$236,000. The Company received a refund in 2007 in the amount of approximately \$79,000, which is reflected in the accompanying statement of operations in discontinued operations under taxes refunded on sale of real estate. The operating expenses recorded during the three and nine months ended September 30, 2008 are legal fees related to the Canadian entities which have been dissolved.

The Company classified its two Canadian properties as discontinued operations, in accordance with the provisions of SFAS 144. The table below summarizes the components of income (loss) from discontinued operations:

	For the three months ended September 30,		For the nine months ended September 30,	
	2008	2007	2008	2007
Operating (expense) income	\$ (1,322)	\$ 5,975	\$ (34,956)	\$ 471
Net realized income from foreign currency transactions		33,487		33,550
Taxes refunded on sale of real estate				78,667
(Loss) income from discontinued operations	\$ (1,322)	\$ 39,462	\$ (34,956)	\$ 112,688

#### 6. Mortgage Note Receivable

On April 15, 2005, the Company originated a mortgage loan in the amount of \$10.0 million, collateralized by an office building in McLean, Virginia, where the Company's Adviser and Administrator are subtenants in the building. This 12 year mortgage loan accrues interest at the greater of 7.5% per year or the one month London Interbank Offered Rate ( LIBOR ) rate plus 6.0% per year, with a ceiling of 10.0%. The mortgage loan is interest only for the first nine years of the term, with payments of principal commencing after the initial period. The balance of the principal and all interest remaining is due at the end of the 12 year term. At September 30, 2008, the interest rate was 8.5%.

#### 7. Mortgage Notes Payable, Line of Credit and Short-Term Loan

The Company's mortgage notes payable, line of credit and short-term loan as of September 30, 2008 and December 31, 2007 are summarized below:

	Date of Issuance/ Assumption	Principal Maturity Date	Stated Interest Rate at September 30, 2008 <sup>(1)</sup>	Principal Balance Outstanding September 30, 2008	December 31, 2007
Fixed-Rate Mortgage Notes Payable:					
	3/16/2005	4/1/2030	6.33%	\$ 2,958,913	\$ 3,003,582
	8/25/2005	9/1/2015	5.33%	21,448,474	21,664,476
	9/12/2005	9/1/2015	5.21%	12,588,000	12,588,000
	12/21/2005	12/8/2015	5.71%	19,280,744	19,456,000
	2/21/2006	12/1/2013	5.91%	9,369,889	9,480,063
	2/21/2006	6/30/2014	5.20%	19,529,866	19,782,270
	3/29/2006	4/1/2016	5.92%	17,000,000	17,000,000
	4/27/2006	5/5/2016	6.58%	14,324,718	14,514,214
	11/22/2006	12/1/2016	5.76%	14,309,000	14,309,000
	12/22/2006	1/1/2017	5.79%	21,846,000	21,846,000
	2/8/2007	3/1/2017	6.00%	13,775,000	13,775,000
	6/5/2007	6/8/2017	6.11%	14,240,000	14,240,000
	9/6/2007	12/11/2015	5.81%	4,442,289	4,487,205
	10/15/2007	11/8/2017	6.63%	15,855,560	15,974,661

Edgar Filing: GLADSTONE COMMERCIAL CORP - Form 10-Q

	8/29/2008	6/1/2016	6.80%	6,441,772	
	9/15/2008	10/1/2010	6.85%	48,015,000	
Total Fixed-Rate Mortgage Notes Payable:				255,425,225	202,120,471
Variable-Rate Line of Credit:	12/29/2006	12/29/2009 <sup>(2)</sup>	LIBOR + 1.9%	10,200,000	4,400,000
Variable-Rate Short-Term Loan:	12/21/2007	12/21/2008 <sup>(3)</sup>	LIBOR + 2.75%	20,000,000	20,000,000
Total Mortgage Notes Payable, Line of Credit and Short-Term Loan				\$ 285,625,225	\$ 226,520,471

(1) The weighted average interest rate on all debt outstanding at September 30, 2008 was approximately 5.92%.

(2) The line of credit may be extended for a one-year period at the Company's option, subject to certain conditions.

(3) The short-term loan may be extended for a six-month period at the Company's option, subject to certain conditions.

*Mortgage Notes Payable*

As of September 30, 2008 the Company had 16 fixed-rate mortgage notes payable, collateralized by a total of 55 properties. The obligor under each of these notes is a wholly-owned separate borrowing entity, which owns the real estate collateral. The Company is not a co-borrower but has limited recourse liabilities that could result from: 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, and physical waste or damage to the property resulting from a borrower's gross negligence or willful misconduct. The Company also indemnifies 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 September 30, 2008 was approximately 6.0%.

The fair market value of all fixed-rate mortgage notes payable outstanding as of September 30, 2008 was approximately \$231.4 million, as compared to the carrying value stated above of approximately \$255.4 million. The fair market value is calculated based on a discounted cash flow analysis, using interest rates based on management's estimate of interest rates on long-term debt with comparable terms.

On August 29, 2008, the Company assumed approximately \$6.4 million of indebtedness pursuant to a long-term note payable from GE Commercial Mortgage Financial Corporation (GE), in connection with the Company's acquisition, on the same date, of a property located in Chalfont, Pennsylvania. The note accrues interest at a rate of 6.8% per year, and the Company may not repay this note prior to maturity, or the Company may be subject to a substantial prepayment penalty. The note matures on June 1, 2016.

On September 15, 2008, through wholly-owned subsidiaries, the Company borrowed approximately \$48.0 million pursuant to a long-term note payable from GE, which is collateralized by security interests in 15 properties. The note accrues interest at a rate of 6.85% per year and the Company may not repay this note prior to maturity, or the Company would be subject to a substantial prepayment penalty. The note has a maturity date of October 1, 2010, with three annual extension options through October 1, 2013. The Company used the proceeds from the note to pay down the outstanding balance on the line of credit.

Scheduled principal payments of mortgage notes payable are as follows:

	Scheduled principal payments
Three months ending December 31, 2008	\$ 467,668
Year ending December 31, 2009	2,380,065
2010	50,539,216
2011	2,820,750
2012	3,107,172
2013	11,837,278
Thereafter	184,273,076
	\$ 255,425,225

*Line of Credit*

On December 29, 2006, the Company entered into a \$75 million senior revolving credit agreement with a syndicate of banks led by KeyBank National Association ( KeyBank ), which matures on December 29, 2009 with an option to extend for an additional year. The Company subsequently increased the availability under the line of credit to \$95 million in November 2007. The interest rate charged on the advances under the facility is based on the LIBOR, the prime rate or the federal funds rate, depending on market conditions, and adjusts periodically. The unused portion of the line of credit is subject to a fee of 0.15% per year. The Company's ability to access this funding source is subject to the Company continuing to meet customary lending requirements such as compliance with financial and operating covenants and meeting certain lending limits. One such covenant requires the Company to limit its distributions to stockholders to 95% of its FFO, beginning with the quarter ended December 31, 2007. In addition, the maximum amount the Company may draw under this agreement is based on a percentage of the value of properties pledged as collateral to the banks, which must meet agreed upon eligibility standards. As the Company arranges for long-term mortgages for these pledged properties, the banks will release the properties from the line of credit and reduce the availability under the line of credit by the advanced amount of the removed property. Conversely, as the Company purchases new properties meeting the eligibility standards, the Company may pledge these new properties to obtain additional advances under this agreement. The availability under the line of credit may also be reduced by letters of credit used in the ordinary course of business. The Company may use the advances under the line of credit for both general corporate purposes and the acquisition of new investments. As of September 30, 2008, there was approximately \$10.2 million outstanding under the line of credit at an interest rate of approximately 5.7%, and approximately \$5.1 million outstanding under letters of credit at a weighted average interest rate of approximately 2.0%. At September 30, 2008, the remaining borrowing capacity available under the line of credit was \$79.7 million, and the Company was in compliance with all covenants under the line of credit.

*Short-Term Loan*

On December 21, 2007, the Company entered into a \$20 million unsecured term loan with KeyBank, which matures on December 21, 2008 with an option to extend for an additional six months. The Company can exercise the option to extend the term as long as it is in compliance with all covenants under the loan at the time it exercises its option. The interest rate charged on the loan is based on the LIBOR, the prime rate or the federal funds rate, depending on market conditions, and adjusts periodically. The Company's ability to maintain this funding source is subject to it continuing to meet customary lending requirements such as compliance with financial and operating covenants and meeting certain lending limits. One such covenant requires the Company to limit distributions to its stockholders to 95% of its FFO beginning with the quarter ended December 31, 2007. As of September 30, 2008, the interest rate on the short-term loan was approximately 5.2%, and the Company was in compliance with all covenants under the short-term loan.

**8. Stockholders Equity**

The following table summarizes the changes in stockholders' equity for the nine months ended September 30, 2008:

	Common Stock	Preferred Stock	Capital in Excess of Par Value	Notes Receivable From Sale of Common Stock	Distributions in Excess of Accumulated Earnings	Total Stockholders Equity
Balance at December 31, 2007	\$ 8,565	\$ 2,150	\$ 170,640,979	\$ (2,769,923)	\$ (25,513,703)	\$ 142,368,068
Repayment of Principal on Notes Receivable				140,077		140,077

Distributions Declared to Common and Preferred Stockholders							(12,706,239)	(12,706,239)
Net income							3,777,707	3,777,707

Balance at  
September 30, 2008    \$ 8,565    \$ 2,150    \$ 170,640,979    \$ (2,629,846)    \$ (34,442,235)    \$ 133,579,613

Dividends paid per common share for the three and nine months ended September 30, 2008 were \$0.375 and \$1.125 per share, respectively, and for the three and nine months ended September 30, 2007 were \$0.36 and \$1.08, respectively. Dividends paid per share of Series A Preferred Stock for both the three and nine months ended September 30, 2008 and 2007 were approximately \$0.48 and \$1.45 per share, respectively. Dividends paid per share of Series B Preferred Stock for both the three and nine months ended September 30, 2008 and 2007 were approximately \$0.47 and \$1.41 per share, respectively.

Edgar Filing: GLADSTONE COMMERCIAL CORP - Form 10-Q

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

Date Issued	Number of Options Exercised	Strike Price of Options Exercised	Amount of Promissory Note Issued to Employees	Outstanding		Term of Note	Interest Rate on Note
				Balance of Employee Loans at 9/30/08			
Sep-04	25,000	\$ 15.00	\$ 375,000	\$ 366,348		9 years	5.00%
Apr-06	12,422	16.10	199,994	199,994		9 10 years	7.77%
May-06	50,000	16.85	842,500	842,500		10 years	7.87%
May-06	15,000	16.10	241,500	241,500		10 years	7.87%
May-06	2,500	16.01	40,000	38,544		10 years	7.87%
May-06	2,000	16.10	32,200	32,200		10 years	7.87%
May-06	2,000	16.10	32,200	32,200		10 years	7.87%
May-06	2,000	16.68	33,360	33,360		10 years	7.87%
May-06	2,000	15.00	30,000	30,000		9 years	7.87%
Oct-06	12,000	16.10	193,200	193,200		9 years	8.17%
Nov-06	25,000	15.00	375,000	245,000		9 10 years	8.15%
Dec-06	25,000	15.00	375,000	375,000		years	8.12%
	174,922		\$ 2,769,954	\$ 2,629,846			

In accordance with the note agreements with each employee, they are required to remit interest payments to the Company on their outstanding loan balance quarterly in arrears. In accordance with Emerging Issues Task Force No. 85-1, Classifying Notes Received for Sale of Stock, receivables from employees for the issuance of capital stock to employees prior to the receipt of cash payment should be reflected in the balance sheet as a reduction to stockholders' equity. Therefore, these notes were recorded as loans to employees and are included in the equity section of the accompanying consolidated balance sheets.

**9. Segment Information**

As of September 30, 2008, the Company's operations were derived from two operating segments. One segment purchases real estate (land, buildings and other improvements), which is simultaneously leased to existing users and the other segment extends mortgage loans and collects principal and interest payments. The following table



Edgar Filing: GLADSTONE COMMERCIAL CORP - Form 10-Q

summarizes the Company's consolidated operating results and total assets by segment as of and for the three and nine months ended September 30, 2008 and 2007:

	As of and for the three months ended September 30, 2008				As of and for the nine months ended September 30, 2008			
	Real Estate	Real Estate	Other	Total	Real Estate	Real Estate	Other	Total
	Leasing	Lending			Leasing	Lending		
Operating revenues	\$ 10,240,697	\$ 216,446	\$	\$ 10,457,143	\$ 29,522,531	\$ 673,548	\$	\$ 30,196,079
Operating expenses	(3,523,080)		(1,594,404)	(5,117,484)	(10,204,526)		(4,400,483)	(14,605,009)
Other expense	(3,183,823)		(1,012,955)	(4,196,778)	(9,128,081)		(2,650,326)	(11,778,407)
Discontinued operations	(1,322)			(1,322)	(34,956)			(34,956)
Net income	\$ 3,532,472	\$ 216,446	\$ (2,607,359)	\$ 1,141,559	\$ 10,154,968	\$ 673,548	\$ (7,050,809)	\$ 3,777,707
Total Assets	\$ 409,461,178	\$ 10,070,714	\$ 10,751,163	\$ 430,283,055	\$ 409,461,178	\$ 10,070,714	\$ 10,751,163	\$ 430,283,055
	As of and for the three months ended September 30, 2007				As of and for the nine months ended September 30, 2007			
	Real Estate	Real Estate	Other	Total	Real Estate	Real Estate	Other	Total
	Leasing	Lending			Leasing	Lending		
Operating revenues	\$ 8,104,953	\$ 255,555	\$	\$ 8,360,508	\$ 23,065,514	\$ 758,333	\$	\$ 23,823,847
Operating expenses	(2,902,795)		(1,082,174)	(3,984,969)	(8,406,164)		(3,239,038)	(11,645,202)
Other expense	(2,693,509)		(131,032)	(2,824,541)	(7,502,386)		(111,832)	(7,614,218)
Discontinued operations	39,462			39,462	112,688			112,688
Net income	\$ 2,548,111	\$ 255,555	\$ (1,213,206)	\$ 1,590,460	\$ 7,269,652	\$ 758,333	\$ (3,350,870)	\$ 4,677,115
Total Assets	\$ 343,702,960	\$ 10,083,333	\$ 7,559,584	\$ 361,345,877	\$ 343,702,960	\$ 10,083,333	\$ 7,559,584	\$ 361,345,877

The amounts included under the other column in the tables above include other income, which consists of interest income and any other miscellaneous income earned, operating expenses that were not specifically derived from either operating segment, and other expense that is not specifically related to either operating segment.

### 10. Pro Forma Financial Information

The Company acquired six properties during the nine months ended September 30, 2008. The following table reflects pro-forma condensed consolidated income statements as if the six properties were acquired as of the beginning of the periods presented:

	For the three months ended September 30,		For the nine months ended September 30,	
	2008	2007	2008	2007
<b>Operating Data:</b>				
Total operating revenue	\$ 10,719,521	\$ 9,730,400	\$ 32,138,406	\$ 27,933,522
Total operating expenses	(5,313,745)	(4,720,207)	(15,810,891)	(13,998,829)
Other expense	(4,320,745)	(3,427,951)	(11,984,983)	(8,217,628)
Income from continuing operations	1,085,031	1,582,242	4,342,532	5,717,065
Dividends attributable to preferred stock	(1,023,437)	(1,023,438)	(3,070,312)	(3,070,312)
Net income from continuing operations available to common stockholders	\$ 61,594	\$ 558,804	\$ 1,272,220	\$ 2,646,753

### Share and Per Share Data:

Basic & diluted net income from continuing operations	\$ 0.01	\$ 0.07	\$ 0.15	\$ 0.31
Weighted average shares outstanding-basic & diluted	8,565,264	8,565,264	8,565,264	8,565,264

These pro-forma condensed consolidated income statements are not necessarily indicative of what actual results would have been had the Company acquired the specified properties as of the beginning of the periods presented.

### 11. Commitments and Contingencies

The Company is required to pay ground lease payments on its Tulsa, Oklahoma property. The lease expires in June 2021. Future operating lease payments under the non-cancelable lease, in effect at September 30, 2008 were as follows:

	Lease Payments
Three months ending December 31, 2008	\$ 33,600
Year ending December 31, 2009	134,400
2010	134,400
2011	134,400
2012	134,400
2013	134,400
Thereafter	1,008,000

### 12. Subsequent Events

On October 7, 2008, the Company's Board of Directors declared cash dividends of \$0.125 per common share, \$0.1614583 per share of the Series A Preferred Stock, and \$0.15625 per share of the Series B Preferred Stock for each

of the months of October, November and December 2008. Monthly dividends will be payable on October 31, 2008, November 28, 2008 and December 31, 2008, to those stockholders of record as of the close of business for the dates of October 23, 2008, November 19, 2008 and December 22, 2008, respectively.

**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. 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, 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 actual results, levels of activity, performance or achievements to be materially different from any future results, levels of activity, performance or achievements expressed or implied by such forward-looking statements. 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 Form 10-Q.*

**OVERVIEW**

**General**

We were 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 and commercial real property and selectively making long-term industrial and commercial mortgage loans. Most of the portfolio of real estate we currently own 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 in the past 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 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 are actively communicating 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.

**Business Environment**

Conditions within the U.S. credit markets in general and the U.S. real estate credit markets in particular continue to experience historical levels of dislocation and stress that began in the summer of 2007. These conditions continue to impact us in a variety of ways, including making it difficult for us to price and finance new investment opportunities on attractive terms. We do not know when market conditions will stabilize, if adverse conditions will intensify or the full extent to which the disruptions will affect us. If market instability persists or intensifies, we may experience challenges in raising additional capital. Continued weak economic conditions could adversely impact the financial condition of one or more of our tenants and therefore, could make a tenant bankruptcy and payment default on the related lease more likely. Currently, all of our properties are fully leased and all but one of our tenants and our borrower are current and paying in accordance with their leases and loan, respectively.

At September 30, 2008, we owned 65 properties totaling approximately 6.3 million square feet, and had one mortgage loan outstanding. The total gross investment in these acquisitions, including the mortgage loan investment, was approximately \$442.9 million at September 30, 2008. Prior to September 30, 2008, we reported the aggregate number of properties we own based on the appraisals obtained in connection with the acquisition of our properties, which occasionally grouped two or more buildings together. At September 30, 2008 we are reporting, and in future periods we will report, our aggregate number of properties based on the number of individual buildings. Below is a summary of the properties we owned as of the respective periods, using the new methodology:

<b>As of:</b>	<b>Total properties owned</b>
December 31, 2006	42
March 31, 2007	46
June 30, 2007	47
September 30, 2007	51
December 31, 2007	59
March 31, 2008	62
June 30, 2008	63
September 30, 2008	65

#### **Recent Events**

*Investment Activities:* During the nine months ended September 30, 2008, we acquired six properties totaling approximately 756,000 square feet for approximately \$53.6 million, and made capital improvements to our properties located in Newburyport, Massachusetts and Arlington, Texas for approximately \$1.8 million, resulting in a total investment of approximately \$55.4 million. Of the total investment, \$48.9 million was funded under our line of credit and the remaining \$6.5 million was funded under a long-term note payable with GE Commercial Mortgage Financial Corporation or GE, assumed in connection with an acquisition.

*Financing Activities:* During the nine months ended September 30, 2008, we had net borrowings under our line of credit of approximately \$5.8 million with approximately \$10.2 million outstanding at September 30, 2008. The proceeds from the line of credit were used to fund the six acquisitions during the nine-month period and to fund capital improvements to our properties located in Newburyport, Massachusetts and Arlington, Texas. In September 2008, we borrowed approximately \$48.0 million pursuant to a long-term note payable with GE, collateralized by security interests in 15 of our properties. The proceeds from the long-term note payable were used to pay down the line of credit.

#### **Our Investment Adviser and Administrator**

Gladstone Management Corporation, or our Adviser, is led by a management team which has extensive experience in our lines of business. Our Adviser also has a wholly-owned subsidiary, Gladstone Administration, LLC, or the Administrator, which employs our chief financial officer, chief compliance officer, controller, treasurer and their respective staffs. All of our executive officers are officers or directors, or both, of our Adviser and our Administrator.

Our Adviser and Administrator also provide investment advisory and administrative services to our affiliates, Gladstone Capital Corporation and Gladstone Investment Corporation, both publicly traded business development companies, as well as Gladstone Land Corporation, a private agricultural real estate company. All of our directors and executive officers serve as either directors or executive officers, or both, of Gladstone Capital Corporation and Gladstone Investment Corporation. In the future, our Adviser may provide investment advisory and administrative services to other funds, both public and private, of which it is the sponsor.

Our Adviser was organized as a corporation under the laws of the State of Delaware on July 2, 2002, and is a registered investment adviser under the Investment Advisers Act of 1940, as amended. Our Adviser is headquartered in McLean, Virginia, a suburb of Washington D.C., and also has offices in New York, New Jersey, Pennsylvania, Illinois, Texas, Georgia and Washington.



### **Investment Advisory and Administration Agreements**

We have been externally managed pursuant to a contractual investment advisory arrangement with our Adviser, under which our Adviser has directly employed all of our personnel and paid its payroll, benefits, and general expenses directly. Our initial investment advisory agreement with our Adviser, which we refer to as the Initial Advisory Agreement, was in place from August 12, 2003 through December 31, 2006. On January 1, 2007, we entered into an amended and restated investment advisory agreement with our Adviser, which we refer to as the Amended Advisory Agreement, and an administration agreement, which we refer to as the Administration Agreement, with our Administrator.

Under the terms of the Initial Advisory Agreement and the Amended Advisory Agreement, we were and remain 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. During the three and nine months ended September 30, 2008, the total amount of these expenses that we incurred was approximately \$4.8 million and \$13.8 million, respectively.

During the three and nine months ended September 30, 2007, the total amount of these expenses that we incurred was approximately \$3.4 million and \$9.8 million, respectively. All of these charges are incurred directly by us rather than by our Adviser for our benefit. Accordingly, we did not make any reimbursements to our Adviser for these amounts. In addition, we are also responsible for all fees charged by third parties that are directly related to our business, which may include real estate brokerage fees, mortgage placement fees, lease-up fees and transaction structuring fees (although we may be able to pass some or all of such fees on to our tenants and borrowers). During the three and nine months ended September 30, 2008 and 2007, none of these expenses were incurred by us directly. The actual amount of such fees that we incur in the future will depend largely upon the aggregate costs of the properties we acquire, the aggregate amount of mortgage loans we make, and the extent to which we are able to shift the burden of such fees to our tenants and borrowers. Accordingly, the amount of these fees that we will pay in the future is not determinable at this time.

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

The Amended 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, and an incentive fee based on funds from operations, or FFO. For purposes of calculating the incentive fee, FFO includes any realized capital gains and capital losses, less any dividends paid on preferred stock, but FFO does not include any unrealized capital gains or losses. The incentive fee will reward our Adviser if our quarterly FFO, before giving effect to any incentive fee (pre-incentive fee FFO), exceeds 1.75%, or 7% annualized, (the hurdle rate) of total stockholders' equity, less the recorded value of any preferred stock. Our Adviser will receive 100% of the amount of the pre-incentive fee FFO that exceeds the hurdle rate, but is less than 2.1875% of our pre-incentive fee FFO. Our Adviser will also receive an incentive fee of 20% of the amount of our pre-incentive fee FFO that exceeds 2.1875%. The incentive fee may be reduced because of our line of credit covenant which limits distributions to our stockholders to 95% of FFO.

For the three and nine months ended September 30, 2008, the base management fee was \$404,108 and \$1,255,833, respectively. For the three and nine months ended September 30, 2007, the base management fee was \$459,202 and \$1,412,337, respectively. For the three and nine months ended September 30, 2008, we recorded an incentive fee of \$793,787 and \$2,300,286, respectively, offset by a credit from an unconditional and irrevocable voluntary waiver issued by the Adviser of \$205,876 and \$941,928, respectively, for a net incentive fee for the three and nine months ended September 30, 2008 of \$587,911 and \$1,358,358, respectively. For the three and nine months ended September 30, 2007, we recorded an incentive fee of \$677,104 and \$1,896,677, respectively, offset by a credit from an unconditional and irrevocable voluntary waiver issued by the Adviser of \$526,991 and \$1,746,564, respectively, for a net incentive fee for both the three and nine months ended September 30, 2007 of \$150,113. Our Board of Directors accepted our Adviser's offer to waive a portion of the incentive fee for the three and nine months ended September 30, 2008 and 2007, in order to maintain the current level of distributions to our stockholders. 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 waiver, in whole or in part.





#### *Administration Agreement*

Under the Administration Agreement, we pay separately for our allocable portion of our Administrator's overhead expenses in performing its obligations including, but not limited to, rent for employees of our Administrator, and our allocable portion of the salaries and benefits expenses of our chief financial officer, chief compliance officer, controller, treasurer and their respective staffs. For the three and nine months ended September 30, 2008, we incurred \$238,241 and \$724,978, respectively, for the administration fee. For the three and nine months ended September 30, 2007, we incurred \$175,852 and \$592,996, respectively, for the administration fee.

#### **Critical Accounting Policies**

The preparation of our financial statements in accordance with generally accepted accounting principles in the United States of America, or GAAP, requires management to make judgments that are subjective in nature in order to make certain estimates and assumptions. Management relies on its experience, collects historical data and current market data, and analyzes this information in order to arrive at what it believes to be reasonable estimates. Under different conditions or assumptions, materially different amounts could be reported related to the accounting policies described below. In addition, application of these accounting policies involves the exercise of judgments on 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 consolidated financial statements included elsewhere in this report. 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.

#### *Allocation of Purchase Price*

When we acquire real estate, we allocate the purchase price to the acquired tangible assets and liabilities, consisting of land, building, tenant improvements, long-term debt and identified intangible assets and liabilities, consisting of the value of above-market and below-market leases, the value of in-place leases, the value of unamortized lease origination costs, the value of tenant relationships and the value of capital lease obligations, based in each case on their fair values.

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

The amount of acquisition costs 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 changes in the purchase price allocation among our assets could have a material impact on our FFO, which is used by investors of REITs to evaluate our operating performance; and

The period of time that tangible and intangible assets are depreciated over 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, we depreciate our buildings over 39 years, and land is not depreciated. These differences in timing could have a material impact on our result 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. If circumstances support the possibility of impairment, we prepare a projection of the undiscounted future cash flows, without interest charges, of the specific property and determine if the investment in such property is recoverable. If impairment is 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. 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 if impairment is deemed to have occurred and the amount of impairment loss we would recognize.

#### *Provision for Loan Losses*

Our accounting policies require that we reflect in our financial statements an allowance for estimated credit losses with respect to mortgage loans we have made based upon our evaluation of known and inherent risks associated with our private lending assets. Management reflects provisions for loan losses based upon our assessment of general market conditions, our internal risk management policies and credit risk rating system, industry loss experience, our assessment of the likelihood of delinquencies or defaults, and the value of the collateral underlying our investments. Any material changes to the estimates and assumptions used in this analysis could have a significant impact on our results of operations.

#### *Recently Issued Accounting Pronouncements*

Refer to Note 1 in the accompanying consolidated financial statements for a summary of all recently issued accounting pronouncements.

#### **Results of Operations**

Our weighted-average yield on the portfolio as of September 30, 2008 was approximately 9.53%. Our weighted-average yields on the six properties acquired during the nine months ended September 30, 2008 were as follows:

<b>Date Acquired</b>	<b>Property Location</b>	<b>Weighted-Average Yield</b>
1/29/08	Reading, Pennsylvania	9.95%
2/26/08	Fridley, Minnesota	8.93%
3/31/08	Concord Township, Ohio	11.27%
4/30/08	Pineville, North Carolina	11.06%
8/29/08	Marietta, Ohio	11.07%
8/29/08	Chalfont, Pennsylvania	9.01%

The weighted-average yield on our portfolio is calculated by taking the annualized straight-line rent, reflected as rental income on our consolidated statements of operations, or mortgage interest payments, reflected as interest income from mortgage notes receivable on our consolidated statements of operations, of each acquisition or mortgage loan as a

percentage of the acquisition or loan price, as applicable. The weighted-average yield does not take into account the interest expense incurred on the financings placed on our properties.

Edgar Filing: GLADSTONE COMMERCIAL CORP - Form 10-Q

A comparison of our operating results for the three and nine months ended September 30, 2008 and 2007 is below:

	For the three months ended September 30,				For the nine months ended September 30,			
	2008	2007	\$ Change	% Change	2008	2007	\$ Change	% Change
Operating revenues								
Rental income	\$ 10,157,553	\$ 8,024,305	\$ 2,133,248	27%	\$ 29,269,036	\$ 22,834,663	\$ 6,434,373	28%
Interest income from mortgage notes receivable	216,446	255,555	(39,109)	-15%	673,548	758,333	(84,785)	-11%
Tenant recovery revenue	83,144	80,648	2,496	3%	253,495	230,851	22,644	10%
Total operating revenues	10,457,143	8,360,508	2,096,635	25%	30,196,079	23,823,847	6,372,232	27%
Operating expenses								
Depreciation and amortization	3,262,903	2,668,383	594,520	22%	9,435,690	7,722,349	1,713,341	22%
Property operating expenses	225,020	204,972	20,048	10%	670,442	597,273	73,169	12%
Base management fee	404,108	459,202	(55,094)	-12%	1,255,833	1,412,337	(156,504)	-11%
Incentive fee	793,787	677,104	116,683	17%	2,300,286	1,896,677	403,609	21%
Administration fee	238,241	175,852	62,389	35%	724,978	592,996	131,982	22%
Professional fees	117,857	118,371	(514)	0%	362,584	442,479	(79,895)	-18%
Insurance	43,354	53,943	(10,589)	-20%	126,947	171,275	(44,328)	-26%
Directors fees	54,702	66,250	(11,548)	-17%	161,202	174,750	(13,548)	-8%
Stockholder related expense	42,232	40,991	1,241	3%	271,430	215,969	55,461	26%
Asset retirement obligation expense	35,157	29,440	5,717	19%	98,394	86,542	11,852	14%
General and administrative	105,999	17,452	88,547	507%	139,151	79,119	60,032	76%

Edgar Filing: GLADSTONE COMMERCIAL CORP - Form 10-Q

Total operating expenses before credit from Adviser	5,323,360	4,511,960	811,400	18%	15,546,937	13,391,766	2,155,171	16%
Credit to incentive fee	(205,876)	(526,991)	321,115	-61%	(941,928)	(1,746,564)	804,636	-46%
Total operating expenses	5,117,484	3,984,969	1,132,515	28%	14,605,009	11,645,202	2,959,807	25%
Other income (expense)								
Interest income from temporary investments	4,559	33,105	(28,546)	-86%	20,796	325,390	(304,594)	-94%
Interest income employee loans	49,624	52,728	(3,104)	-6%	152,620	169,608	(16,988)	-10%
Other income	7,500	9,896	(2,396)	-24%	56,493	28,127	28,366	101%
Interest expense	(4,258,461)	(2,920,270)	(1,338,191)	46%	(12,008,316)	(8,137,343)	(3,870,973)	48%
Total other expense	(4,196,778)	(2,824,541)	(1,372,237)	49%	(11,778,407)	(7,614,218)	(4,164,189)	55%
Income from continuing operations	1,142,881	1,550,998	(408,117)	-26%	3,812,663	4,564,427	(751,764)	-16%
Discontinued operations								
Loss from discontinued operations	(1,322)	5,975	(7,297)	-122%	(34,956)	471	(35,427)	-7522%
Net realized income from foreign currency transactions		33,487	(33,487)	-100%		33,550	(33,550)	-100%
Taxes refunded on				0%		78,667	(78,667)	-100%

Edgar Filing: GLADSTONE COMMERCIAL CORP - Form 10-Q

sale of real estate								
Total discontinued operations	(1,322)	39,462	(40,784)	-103%	(34,956)	112,688	(147,644)	-131%
Net income	1,141,559	1,590,460	(448,901)	-28%	3,777,707	4,677,115	(899,408)	-19%
Dividends attributable to preferred stock	(1,023,437)	(1,023,438)	1	0%	(3,070,312)	(3,070,312)		0%
Net income available to common stockholders	\$ 118,122	\$ 567,022	\$ (448,900)	-79%	\$ 707,395	\$ 1,606,803	\$ (899,408)	-56%

*Operating Revenues*

Rental income increased for the three and nine months ended September 30, 2008, as compared to the three and nine months ended September 30, 2007, primarily as a result of the 14 properties acquired between September 30, 2007 and September 30, 2008, coupled with properties acquired during the nine months ended September 30, 2007 that were held for the full nine-month period in 2008.

Interest income from mortgage notes receivable decreased for the three and nine months ended September 30, 2008, as compared to the three and nine months ended September 30, 2007, primarily because interest income on our mortgage loan is based on the London Interbank Offered Rate, or LIBOR, which has significantly decreased over the past year.

Tenant recovery revenue remained relatively flat for the three months ended September 30, 2008 as compared to the three months ended September 30, 2007. Tenant recovery revenue increased for the nine months ended September 30, 2008, as compared to the nine months ended September 30, 2007, primarily as a result of the reimbursement of the ground lease payments on our Tulsa, Oklahoma property acquired in March 2007, which was held for the entire nine-month period in 2008.

*Operating Expenses*

Depreciation and amortization expenses increased during the three and nine months ended September 30, 2008, as compared to the three and nine months ended September 30, 2007, as a result of the 14 properties acquired between September 30, 2007 and September 30, 2008, and properties acquired during the nine months ended September 30, 2007 that were held for the full nine-month period in 2008.

Property operating expenses consist of franchise taxes, management fees, insurance, ground lease payments on our Tulsa, Oklahoma property acquired in March 2007 and overhead expenses paid on behalf of certain of our properties. Property operating expenses increased during the three and nine months ended September 30, 2008, as compared to the three and nine months ended September 30, 2007, primarily as a result of repairs on several of our properties. In addition, property operating expenses for the entire nine months ended September 30, 2008 included ground lease payments on our Tulsa, Oklahoma property acquired in March 2007.

The base management fee decreased for the three and nine months ended September 30, 2008, as compared to the three and nine months ended September 30, 2007, as a result of a decrease in total common stockholders' equity, the main component of the calculation. The calculation of the base management fee is described in detail above under *Investment Advisory and Administration Agreements*.

The incentive fee increased for the three and nine months ended September 30, 2008, as compared to the three and nine months ended September 30, 2007, due to the decrease in total common stockholders' equity, coupled with the increase in FFO. The calculation of the incentive fee is described in detail above under *Investment Advisory and Administration Agreements*.

The administration fee increased for the three and nine months ended September 30, 2008 and 2007, primarily as a result of the increased number of employees of our Administrator, coupled with an increase in overhead expenses allocated by our Administrator. The calculation of the administrative fee is described in detail above under *Investment Advisory and Administration Agreements*.

Professional fees, consisting primarily of legal and accounting fees, remained relatively flat during the three months ended September 30, 2008, as compared to the three months ended September 30, 2007. Professional fees decreased during the nine months ended September 30, 2008, as compared to the nine months ended September 30, 2007, primarily as a result of a reduction in legal fees paid during the nine months ended September 30, 2008 combined with fees incurred during the three and nine months ended September 30, 2007 for state tax research and costs related to the implementation of FIN 48, which were not incurred during the nine months ended September 30, 2008.

Insurance expense consists of the premiums paid for directors and officers insurance, which is renewed annually each September. Insurance expense decreased for the three and nine months ended September 30, 2008, as compared to the three and nine months ended September 30, 2007, because of a decrease in the premiums for the period from September 2007 through September 2008.

Directors' fees decreased during the three and nine months ended September 30, 2008, as compared to the three and nine months ended September 30, 2007, primarily as a result of fewer meetings occurring in the three and nine months ended September 30, 2008.

Stockholder related expense increased for the three and nine months ended September 30, 2008, as compared to the three and nine months ended September 30, 2007, primarily as a result of the increase in our costs associated with printing and filing the annual report, coupled with costs associated with the solicitation of the stockholder vote for the 2008 annual meeting.

Asset retirement obligation expense increased for the three and nine months ended September 30, 2008, as compared to the three and nine months ended September 30, 2007, primarily as a result of a property acquired between September 30, 2007 and September 30, 2008, which was required to recognize an asset retirement liability, coupled with a property acquired where a liability was recorded during the nine months ended September 30, 2007 that was held for the full period in 2008.

General and administrative expenses increased for the three and nine months ended September 30, 2008, as compared to the three and nine months ended September 30, 2007, primarily as a result of capitalized fees for financings that did not materialize, and as such, were written off.

*Other Income and Expense*

Interest income from temporary investments decreased during the three and nine months ended September 30, 2008, as compared to the three and nine months ended September 30, 2007. The decrease was primarily a result of the decrease in our average cash balances during the nine months ended September 30, 2008.

During the three and nine months ended September 30, 2008, interest income on employee loans decreased, as compared to the three and nine months ended September 30, 2007. This decrease was a result of employees who paid off their loans during 2008, coupled with other partial principal repayments over the periods.

Other income was relatively flat during the three months ended September 30, 2008, as compared to the three months ended September 30, 2007. Other income increased for the nine months ended September 30, 2008 as compared to the nine months ended September 30, 2007, primarily because of a real estate tax reimbursement we received from our property located in Sterling Heights, Michigan.

Interest expense increased for the three and nine months ended September 30, 2008, as compared to the three and nine months ended September 30, 2007. This was primarily a result of the long term financings we closed on 14 of our properties subsequent to September 30, 2007, coupled with an increased amount outstanding on our line of credit during the three and nine months ended September 30, 2008. In September 2008, we paid down the outstanding balance on the line of credit using proceeds from the \$48.0 million long-term note payable from GE.

*Discontinued Operations*

The loss from discontinued operations is the expense related to our two Canadian properties, which were sold in July 2006. The expense relates to legal fees associated with the dissolution of the entities which sold the properties. The 2006 tax returns were filed in March 2007, and we were due a refund of approximately \$79,000, which is reflected on the statements of operations under taxes refunded on sale of real estate for the nine months ended September 30, 2007.

*Net Income Available to Common Stockholders*

Net income available to common stockholders decreased for the three and nine months ended September 30, 2008, as compared to the three and nine months ended September 30, 2007. This decrease was primarily a result of increased interest expense from the increased number of properties which have long-term financing, partially offset by the increase in the size of our portfolio of investments in the past year and the corresponding increase in our revenues and the other events described above.

**Liquidity and Capital Resources**

*Cash and Cash Equivalents*

At September 30, 2008, we had approximately \$3.1 million in cash and cash equivalents. We have access to our existing line of credit with an available borrowing capacity of \$79.7 million, have obtained mortgages on 55 of our properties and have a \$20.0 million short-term loan. We expect that the funds from our line of credit, additional mortgages and securities offerings will provide us with sufficient capital to make additional investments and to fund our continuing operations for the foreseeable future. As previously discussed in Management's Discussion and Analysis - Business Environment, continued weak economic conditions could adversely affect our ability to obtain additional mortgages collateralized by some or all of our real property in the future, as well as our ability to borrow funds and issue additional equity securities in order to obtain additional capital in the future. We cannot determine the terms of future borrowings or equity issuances or whether we will be able to borrow funds or issue equity on terms favorable to us, or if at all.



*Operating Activities*

Net cash provided by operating activities during the nine months ended September 30, 2008 was approximately \$12.2 million, compared to net cash provided by operating activities of approximately \$12.0 million for the nine months ended September 30, 2007. A majority of cash from operating activities is generated from the rental payments we receive from our tenants and the interest payments we receive from our borrower. 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 and short-term loan, dividend payments, management fees to our Adviser, and other entity level expenses.

*Investing Activities*

Net cash used in investing activities during the nine months ended September 30, 2008 was approximately \$50.1 million, which primarily consisted of the purchase of six properties, as described in the *Recent Events* section above, as compared to net cash used in investing activities during the nine months ended September 30, 2007 of approximately \$85.7 million, which primarily consisted of the purchase of eight properties and one leasehold interest. During the nine months ended September 30, 2008, we purchased five of the six properties using borrowings under our line of credit and assumed the mortgage on the sixth property located in Chalfont, Pennsylvania. During the nine months ended September 30, 2007, we purchased all of the properties using borrowings under our line of credit. Net real estate consisted of the following tenant industry classifications as of September 30, 2008 and December 31, 2007:

Industry Classification	September 30, 2008		December 31, 2007	
	Net Real Estate	Percentage of Net Real Estate	Net Real Estate	Percentage of Net Real Estate
Automobile	\$ 10,906,445	3.0%	\$ 11,072,192	3.4%
Beverage, Food & Tobacco	18,792,486	5.1%	10,655,401	3.3%
Buildings and Real Estate	20,116,878	5.5%	20,504,268	6.3%
Chemicals, Plastics & Rubber	26,175,476	7.1%	15,371,141	4.7%
Containers, Packaging & Glass	16,002,508	4.4%	16,320,658	5.0%
Diversified/Conglomerate Manufacturing	32,437,883	8.8%	25,328,441	7.8%
Diversified/Conglomerate Services	2,569,588	0.7%	2,615,717	0.8%
Electronics	54,585,128	14.8%	55,721,882	17.2%
Healthcare, Education & Childcare	55,307,539	15.0%	43,322,758	13.3%
Home & Office Furnishings	5,180,076	1.4%	5,276,588	1.6%
Insurance	5,696,887	1.5%	5,809,099	1.8%
Machinery	21,686,150	5.9%	12,682,144	3.9%
Oil & Gas	10,878,990	3.0%	11,099,726	3.4%
Personal & Non-Durable Consumer Products	13,024,942	3.5%	13,207,489	4.1%
Personal, Food & Miscellaneous Services	4,408,674	1.2%	4,502,040	1.4%
Printing & Publishing	22,167,679	6.0%	22,594,423	7.0%
Telecommunications	47,778,015	13.0%	48,677,805	15.0%
	\$ 367,715,344	100.0%	\$ 324,761,772	100.0%

Industry groupings are based on management's knowledge of the tenant's operations in the leased space.

*Financing Activities*

Net cash provided by financing activities for the nine months ended September 30, 2008 was approximately \$39.6 million, which primarily consisted of the proceeds from the long-term financing of 15 of our properties and borrowings under our line of credit, partially offset by repayments on our line of credit, principal repayments on

mortgage notes payable, payments for deferred financing costs, and dividend payments. Net cash provided by financing activities for the nine months ended September 30, 2007 was approximately \$39.5 million, which primarily consisted of the proceeds received from the long-term financing of seven of our properties, partially offset by repayments on our line of credit, payments for deferred financing costs, principal repayments on mortgage notes payable and dividend payments.

*Future Capital Needs*

As of September 30, 2008, we had investments in 65 real properties for a net value, including intangible assets, of approximately \$400.2 million and one mortgage loan receivable for \$10.0 million. During the remainder of 2008 and beyond, we intend to complete additional acquisitions of real estate and to originate additional mortgage notes, although there is no guarantee we will be able to do so on favorable terms, if at all. We intend to fund our contractual obligations and acquire additional properties by borrowing all or a portion of the purchase price and collateralizing the mortgages with some or all of our real property, by borrowing against our existing line of credit with an available borrowing capacity of \$79.7 million, or by issuing additional equity securities under an effective registration statement on Form S-3 (File No. 333-147856) we have on file with the Securities and Exchange Commission (the Registration Statement). The Registration Statement permits us to issue, through one or more transactions, up to an aggregate of \$300.0 million in securities consisting of common or preferred stock, of which all \$300 million was available as of September 30, 2008. We may also use these funds for general corporate needs. If we are unable to make any required debt payments on any borrowings, our lenders could foreclose on the properties collateralizing their loans, which could cause us to lose part or all of our investments in such properties. In addition, we need sufficient capital to fund our dividends, and we may require credits to our management fees, issued from our Adviser, in order to meet these obligations, although our Adviser is under no obligation to provide such credits, in whole or in part.

*Mortgage Notes Payable*

On September 15, 2008, through wholly-owned subsidiaries, we borrowed approximately \$48.0 million pursuant to a long-term note payable from GE, which is collateralized by security interests in 15 properties. The note accrues interest at a rate of 6.85% per year and we may not repay this note prior to maturity, or we would be subject to a substantial prepayment penalty. The note has a maturity date of October 1, 2010, with three annual extension options through October 1, 2013. We used the proceeds from the note to pay down the outstanding balance on the line of credit. As of September 30, 2008, we had 16 fixed-rate mortgage notes payable in the aggregate principal amount of approximately \$255.4 million, collateralized by a total of 55 properties with terms ranging from 2 years to 25 years. The weighted-average interest rate on the mortgage notes payable as of September 30, 2008 was approximately 6.0%.

*Line of Credit*

On December 29, 2006, we entered into a \$75 million senior revolving credit agreement with a syndicate of banks led by KeyBank National Association, which matures on December 29, 2009 with an option to extend for an additional year. We subsequently increased the availability under our line of credit to \$95 million in November 2007. The interest rate charged on the advances under the facility is based on LIBOR, the prime rate or the federal funds rate, depending on market conditions, and adjusts periodically. The unused portion of the line of credit is subject to a fee of 0.15% per year. Our ability to access this funding source is subject to us continuing to meet customary lending requirements such as compliance with financial and operating covenants and meeting certain lending limits. One such covenant requires us to limit distributions to our stockholders to 95% of our funds from operations, or FFO, beginning with the quarter ended December 31, 2007. In addition, the maximum amount we may draw under this agreement is based on a percentage of the value of properties pledged as collateral to the banks, which must meet agreed upon eligibility standards. As we arrange for long-term mortgages for these pledged properties, the banks will release the properties from the line of credit and reduce the availability under the line of credit by the advanced amount of the removed property. Conversely, as we purchase new properties meeting the eligibility standards, we may pledge these new properties to obtain additional advances under this agreement. The availability under the line of credit will also be reduced by letters of credit used in the ordinary course of business. We may use the advances under the line of credit for both general corporate purposes and the acquisition of new investments. As of September 30, 2008, there was approximately \$10.2 million outstanding under the line of credit at an interest rate of approximately 5.7%, and approximately \$5.1 million outstanding under letters of credit at a weighted average interest rate of approximately 2.0%. At September 30, 2008, the remaining borrowing capacity available under the line of credit was \$79.7 million, and we were in compliance with all covenants under the line of credit.

*Short-Term Loan*

On December 21, 2007, we entered into a \$20 million unsecured term loan with KeyBank National Association, which matures on December 21, 2008, with an option to extend for an additional nine months. We can exercise the option to extend the term as long as we are in compliance with all covenants under the loan at the time we exercise the option. The interest rate charged on the loan is based on LIBOR, the prime rate or the federal funds rate, depending on market conditions, and adjusts periodically. Our ability to maintain this funding source is subject to us continuing to meet customary lending requirements such as compliance with financial and operating covenants and meeting certain lending limits. One such covenant requires us to limit distributions to our stockholders to 95% of our FFO beginning with the quarter ended December 31, 2007. As of September 30, 2008, the interest rate on the short-term loan was approximately 5.2%, and we were in compliance with all covenants under the short-term loan.

**Off-Balance Sheet Arrangements**

We did not have any off-balance sheet arrangements as defined in Item 303(a)(4)(ii) of SEC Regulation S-K as of September 30, 2008.

**Contractual Obligations**

The following table reflects our significant contractual obligations as of September 30, 2008:

Contractual Obligations	Total	Payments Due by Period			More than 5 Years
		Less than 1 Year	1-3 Years	3-5 Years	
Debt Obligations <sup>(1)</sup>	\$ 285,625,225	\$ 22,257,476	\$ 63,294,033	\$ 6,196,582	\$ 193,877,134
Interest on Debt Obligations <sup>(2)</sup>	96,063,397	12,242,982	30,176,906	23,017,473	30,626,036
Capital Lease Obligations <sup>(3)</sup>	232,301				232,301
Operating Lease Obligations <sup>(4)</sup>	1,713,600	134,400	268,800	268,800	1,041,600
Total	\$ 383,634,523	\$ 34,634,858	\$ 93,739,739	\$ 29,482,855	\$ 225,777,071

(1) Debt obligations represent borrowings under our line of credit, term loan and mortgage notes payable that were outstanding as of September 30, 2008. The line of credit matures in December 2009, with an option to extend for an additional year, and the term loan matures in December 2008 with an option

to extend for an additional six months.

- (2) Interest on debt obligations does not include interest on our borrowings under our line of credit or term loan. The balance and interest rate on our line of credit and term loan are variable and, thus, the amount of interest has not been calculated for purposes of this table.
- (3) Capital lease obligations represent the obligation to purchase the land held under the ground lease on our property located in Fridley, Minnesota.
- (4) Operating lease obligations represent the ground lease payments due on our Tulsa, Oklahoma property. The lease expires in June 2021.

**Funds from Operations**

NAREIT developed FFO, as a relative non-GAAP supplemental measure of operating performance of an equity REIT, in order to recognize that income-producing real estate historically has not depreciated on the 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, 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 preferred share dividends. 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 weighted average common shares outstanding and FFO available to common stockholders divided by weighted average common shares 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, since 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 for comparing us to other REITs. We believe that net income is the most directly comparable GAAP measure to FFO, Basic EPS is the most directly comparable GAAP measure to Basic FFO per share, and that diluted EPS is the most directly comparable GAAP measure to Diluted FFO per share.

The following table provides a reconciliation of our FFO for the three and nine months ended September 30, 2008 and 2007, to the most directly comparable GAAP measure, net income, and a computation of basic and diluted FFO per weighted average common share, basic and diluted net income per weighted average common share and the percentage of FFO paid per common share:

	For the three months ended		For the nine months ended	
	September 30,		September 30,	
	2008	2007	2008	2007
Net income	\$ 1,141,559	\$ 1,590,460	\$ 3,777,707	\$ 4,677,115
Less: Dividends attributable to preferred stock	(1,023,437)	(1,023,438)	(3,070,312)	(3,070,312)
Net income available to common stockholders	118,122	567,022	707,395	1,606,803
Add: Real estate depreciation and amortization	3,262,903	2,668,383	9,435,690	7,722,349
Less: Gain on sale of real estate, net of taxes paid				(78,667)
FFO available to common stockholders	\$ 3,381,025	\$ 3,235,405	\$ 10,143,085	\$ 9,250,485
Weighted average shares outstanding basic & diluted	8,565,264	8,565,264	8,565,264	8,565,264
Basic & diluted net income per weighted average common share	\$ 0.01	\$ 0.07	\$ 0.08	\$ 0.19
Basic & diluted FFO per weighted average common share	\$ 0.395	\$ 0.378	\$ 1.184	\$ 1.080
Dividends declared per common share	\$ 0.375	\$ 0.360	\$ 1.125	\$ 1.080

Percentage of FFO paid per common share	95%	95%	95%	100%
---	-----	-----	-----	------

**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 will be exposed to is interest rate risk. We currently own one variable rate loan receivable, certain of our leases contain escalations based on market interest rates, and the interest rate on our existing line of credit and short-term loan is variable. 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. We are also exposed to the effects of interest rate changes as a result of the holding of our cash and cash equivalents in short-term, interest-bearing investments.

To illustrate the potential impact of changes in interest rates on our net income for the three and nine month periods ended September 30, 2008 and 2007, we have performed the following analysis, which assumes that our balance sheet remains constant and 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 impact of a 1% increase and 1% decrease in the one month LIBOR for the three and nine month periods ended September 30, 2008 and 2007.



	Three months ended September 30,		Nine months ended September 30,	
	2008	2007	2008	2007
<b>1% increase in the one month LIBOR</b>				
Change in Rental & Interest Income	\$ 27,308	\$ 9,125	\$ 82,106	\$ 27,375
Change in Interest Expense	77,178	51,111	229,856	151,667
Net decrease	\$ (49,869)	\$ (41,986)	\$ (147,750)	\$ (124,292)
Net Income available to common stockholders	\$ 118,112	\$ 567,022	\$ 707,395	\$ 1,606,803
Net decrease as percentage of Net Income available to common stockholders	-42.2%	-7.4%	-20.9%	-7.7%
<b>1% decrease in the one month LIBOR</b>				
Change in Rental & Interest Income	\$ (24,779)	\$ (9,125)	\$ (75,939)	\$ (27,375)
Change in Interest Expense	\$ (77,178)	\$ (51,111)	\$ (229,856)	\$ (152,222)
Net increase	\$ 52,399	\$ 41,986	\$ 153,916	\$ 124,847
Net Income available to common stockholders	\$ 118,112	\$ 567,022	\$ 707,395	\$ 1,606,803
Net increase as percentage of Net Income available to common stockholders	44.4%	7.4%	21.8%	7.8%

As of September 30, 2008, the fair value of our fixed rate debt outstanding was approximately \$231.4 million. Interest rate fluctuations may affect the fair value of our fixed rate debt instruments. If interest rates on our fixed rate debt instruments, using rates at September 30, 2008, had been one percentage point higher or lower, the fair value of those debt instruments on that date would have decreased or increased by approximately \$11.0 million and \$11.7 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, term loan or long-term debt used 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 this objective, 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, all of which may affect our ability to refinance debt if necessary.

**Item 4. Controls and Procedures**

a) Evaluation of Disclosure Controls and Procedures

As of September 30, 2008, 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 September 30, 2008 in providing a reasonable level of assurance that information we are required to disclose in reports that we file or submit under the Securities Exchange Act of 1934 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 three months ended September 30, 2008 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**PART II OTHER INFORMATION**

**Item 1. Legal Proceedings**

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

**Item 1A. Risk Factors**

Our business is subject to certain risks and events that, if they occur, could adversely affect our financial condition and results of operations and the trading price of our common stock. For a discussion of these risks, please refer to the

Risk Factors section of our Annual Report on Form 10-K for the fiscal year ended December 31, 2007, filed by us with the Securities and Exchange Commission on February 27, 2008, and our Quarterly Report on Form 10-Q for the quarter ended June 30, 2008, filed by us with the Securities and Exchange Commission on August 5, 2008. In connection with our preparation of this quarterly report, we have reviewed and considered these risk factors and have determined that the following risk factors should be read in connection with the existing risk factors disclosed in the Form 10-K for the year ended December 31, 2007 and Form 10-Q for the quarter ended June 30, 2008.

***The current state of the economy and the capital markets increases the possibility of adverse effects on our financial position and results of operations.***

The United States has entered into an economic downturn. Continued weak economic conditions could adversely impact the financial condition of one or more of our tenants and, therefore, could make a tenant bankruptcy and payment default on the related lease more likely. Impaired financial positions and operating results could, in turn, harm our results of operations and affect our ability to access capital under our line of credit. The maximum amount we may draw under our line of credit is based on a percentage of the value of properties pledged as collateral to the banks, which must meet agreed upon eligibility standards. As we arrange for long-term mortgages for these pledged properties, the banks will release the properties from the line of credit and reduce the availability under the line of credit by the advanced amount of the removed property. The economic decline generally, and the disruptions in the capital markets in particular, have decreased liquidity and increased our cost of debt and equity capital which could also impact our ability to raise capital and reduce our volume of new investments. The longer these conditions persist, the greater the probability that these factors could have an adverse effect on our operations and financial results.

***Our ownership of properties through ground leases exposes us to risks which are different than those resulting from our ownership of fee title to other properties.***

We have acquired an interest in certain of our properties by acquiring a leasehold interest in the land underlying the property, and we may acquire additional properties in the future that are subject to similar ground leases. In this situation, we have no economic interest in the land underlying the property and do not control this land. Because we do not control the underlying land, this type of ownership interest poses potential risks for our business because (i) if the ground lease terminates for any reason, we will lose our interest in the property, including any investment that we made in the property, (ii) if our tenant defaults under the previously existing lease, we will continue to be obligated to meet the terms and conditions of the ground lease without the annual amount of ground lease payments reimbursable to us by the tenant, and (iii) if the third party owning the land under the ground lease disrupts our use either permanently or for a significant period of time, then the value of our assets could be impaired and our results of operations could be adversely affected.

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

Not applicable.

**Item 3. Defaults Upon Senior Securities**

Not applicable.

**Item 4. Submission of Matters to a Vote of Security Holders**

No matters were voted on during the three months ended September 30, 2008.

**Item 5. Other Information**

Not applicable.

**Item 6. Exhibits**

**Exhibit Index**

<b>Exhibit</b>	<b>Description of Document</b>
3.1	Amended and Restated Articles of Incorporation, incorporated by reference to Exhibit 3.1 to the Registration Statement on Form S -11 (File No. 333-106024), filed September 11, 2003.
3.2	Bylaws, incorporated by reference to Exhibit 3.2 to the Registration Statement on Form S-11 (File No. 333-106024), filed September 11, 2003.
3.2.1	First Amendment to Bylaws, incorporated by reference to Exhibit 99.1 of the Current Report on Form 8-K (File No. 000-50363), filed July 10, 2007.
4.1	Articles Supplementary Establishing and Fixing the Rights and Preferences of the 7.75% Series A Cumulative Redeemable Preferred Stock, incorporated by reference to Exhibit 3.3 of Form 8-A (File No. 000-50363), filed January 19, 2006.
4.2	Articles Supplementary Establishing and Fixing the Rights and Preferences of the 7.5% Series B Cumulative Redeemable Preferred Stock, incorporated by reference to Exhibit 3.4 of Form 8-A (File No. 000-50363), filed October 19, 2006.
4.3	Form of Certificate for 7.75% Series A Cumulative Redeemable Preferred Stock of Gladstone Commercial Corporation, incorporated by reference to Exhibit 4.1 of Form 8-A (File No. 000-50363), filed January 19, 2006.
4.4	Form of Certificate for 7.5% Series B Cumulative Redeemable Preferred Stock of Gladstone Commercial Corporation, incorporated by reference to Exhibit 4.2 of Form 8-A (File No. 000-50363), filed October 19, 2006.
10.1	Amended and Restated Investment Advisory between the Gladstone Commercial Corporation and Gladstone Management Corporation, dated January 1, 2007, incorporated by reference to Exhibit 99.1 of the Current Report on Form 8-K (File No. 000-50363), filed January 3, 2007 (renewed on July 9, 2008).

<b>Exhibit</b>	<b>Description of Document</b>
10.2	Administration Agreement between Gladstone Commercial Corporation and Gladstone Administration, LLC, dated January 1, 2007 incorporated by reference to Exhibit 99.2 of the Current Report on Form 8-K (File No. 000-50363), filed January 3, 2007 (renewed on July 9, 2008).
11	Computation of Per Share Earnings from Operations (included in the notes to the unaudited financial statements contained in this report).
31.1	Certification of Chief Executive Officer pursuant to section 302 of The Sarbanes-Oxley Act of 2002.
31.2	Certification of Chief Financial Officer pursuant to section 302 of The Sarbanes-Oxley Act of 2002.
32.1	Certification of Chief Executive Officer pursuant to section 906 of The Sarbanes-Oxley Act of 2002.
32.2	Certification of Chief Financial Officer pursuant to section 906 of The Sarbanes-Oxley Act of 2002.

Previously filed  
and  
incorporated by  
reference.

SIGNATURES

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

**Gladstone Commercial Corporation**

Date: November 5, 2008

By: /s/ Harry Brill  
Harry Brill  
Chief Financial Officer

38