GLADSTONE COMMERCIAL CORP
Form 10-Q
April 28, 2014
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2014**

OR

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

COMMISSION FILE NUMBER: 001-33097

GLADSTONE COMMERCIAL CORPORATION

(Exact name of registrant as specified in its charter)

MARYLAND	**02-0681276**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**
1521 WESTBRANCH DRIVE, SUITE 100	
MCLEAN, VIRGINIA	**22102**
(Address of principal executive offices)	**(Zip Code)**

(703) 287-5800

(Registrant s telephone number, including area code)

Not Applicable

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x 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	¨	Non-accelerated filer	¨
Accelerated filer	x (Do not check if a smaller reporting company)	Smaller reporting company	¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No x

The number of shares of the registrant s Common Stock, $0.001 par value, outstanding as of April 28, 2014 was 16,105,958.

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GLADSTONE COMMERCIAL CORPORATION

FORM 10-Q FOR THE QUARTER ENDED

MARCH 31, 2014

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PART I FINANCIAL INFORMATION

Item 1. Financial Statements

Gladstone Commercial Corporation

Condensed Consolidated Balance Sheets

(Dollars in Thousands, Except Share and Per Share Data)

(Unaudited)

	March 31, 2014	December 31, 2013
ASSETS		
Real estate, at cost	$ 627,993	$ 642,353
Less: accumulated depreciation	84,008	81,241
Total real estate, net	543,985	561,112
Lease intangibles, net	78,284	79,632
Real estate and related assets held for sale, net	9,932	
Cash and cash equivalents	5,813	8,546
Restricted cash	3,506	5,051
Funds held in escrow	9,417	8,653
Deferred rent receivable, net	19,520	18,905
Deferred financing costs, net	6,814	6,840
Other assets	1,611	1,786
TOTAL ASSETS	$ 678,882	$ 690,525
LIABILITIES AND STOCKHOLDERS EQUITY		
LIABILITIES		
Mortgage notes payable	$ 426,847	$ 422,602
Borrowings under line of credit	24,100	24,400
Series C mandatorily redeemable preferred stock, par value $0.001 per share; $25 per share liquidation preference; 1,700,000 shares authorized; and 1,540,000 shares issued and outstanding at March 31, 2014 and December 31, 2013, respectively	38,500	38,500
Deferred rent liability, net	5,862	6,015
Asset retirement obligation	3,704	3,884
Accounts payable and accrued expenses	2,186	2,359
Other liabilities related to assets held for sale	178	
Due to Adviser and Administrator (1)	1,160	1,360
Other liabilities	6,495	8,259
Total Liabilities	$ 509,032	$ 507,379

Commitments and contingencies [2]				
STOCKHOLDERS EQUITY				
Series A and B redeemable preferred stock, par value $0.001 per share; $25 per share liquidation preference; 2,300,000 shares authorized and 2,150,000 shares issued and outstanding at March 31, 2014 and December 31, 2013, respectively	$	2	$	2
Senior common stock, par value $0.001 per share; 7,500,000 shares authorized and 402,811 and 374,484 shares issued and outstanding at March 31, 2014 and December 31, 2013, respectively				
Common stock, par value $0.001 per share, 38,500,000 shares authorized and 16,081,365 and 15,662,414 shares issued and outstanding at March 31, 2014 and December 31, 2013, respectively		16		16
Additional paid in capital		305,994		298,751
Notes receivable - employee		(375)		(375)
Distributions in excess of accumulated earnings		(135,787)		(115,248)
Total Stockholders Equity		169,850		183,146
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$	678,882	$	690,525

(1) Refer to Note 2 Related-Party Transactions

(2) Refer to Note 8 Commitments and Contigencies

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

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Gladstone Commercial Corporation

Condensed Consolidated Statements of Operations

(Dollars in Thousands, Except Per Share Data)

(Unaudited)

	For the three months ended March 31, 2014	2013
Operating revenues		
Rental revenue	$ 16,585	$ 13,666
Tenant recovery revenue	551	369
Total operating revenues	17,136	14,035
Operating expenses		
Depreciation and amortization	6,720	4,901
Property operating expenses	1,330	737
Acquisition related expenses	110	185
Base management fee (1)	625	353
Incentive fee (1)	1,240	931
Administration fee (1)	492	362
General and administrative	466	389
Impairment charge	13,958	
Total operating expenses before credit to incentive fee	24,941	7,858
Credit to incentive fee (1)	(1,205)	(585)
Total operating expenses	23,736	7,273
Other income (expense)		
Interest expense	(6,275)	(5,661)
Distributions attributable to Series C mandatorily redeemable preferred stock	(686)	(686)
Other income	47	18
Total other expense	(6,914)	(6,329)
Net (loss) income	(13,514)	433
Distributions attributable to Series A and B preferred stock	(1,023)	(1,023)
Distributions attributable to senior common stock	(100)	(53)
Net loss attributable to common stockholders	$ (14,637)	$ (643)

Earnings per weighted average share of common stock - basic & diluted	$	(0.93)	$	(0.06)
Weighted average shares of common stock outstanding - basic & diluted		15,746,714		11,230,647
Earnings per weighted average share of senior common stock	$	0.26	$	0.26
Weighted average shares of senior common stock outstanding - basic		385,875		204,582

(1) Refer to Note 2 Related-Party Transactions

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

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Gladstone Commercial Corporation

Condensed Consolidated Statements of Cash Flows

(Dollars in Thousands)

(Unaudited)

	For the three months ended March 31, 2014	2013
Cash flows from operating activities:		
Net (loss) income	$ (13,514)	$ 433
Adjustments to reconcile net (loss) income to net cash provided by operating activities:		
Depreciation and amortization	6,720	4,901
Impairment charge	13,958	
Amortization of deferred financing costs	386	405
Amortization of deferred rent asset and liability, net	(92)	(98)
Amortization of discount and premium on assumed debt	(44)	(42)
Asset retirement obligation expense	(180)	31
Increase (decrease) in other assets	298	(465)
Increase in deferred rent receivable	(906)	(826)
Decrease in accounts payable, accrued expenses, and amount due Adviser and Administrator	(372)	(637)
Decrease in other liabilities	(41)	(264)
Leasing commissions paid	(54)	(384)
Net cash provided by operating activities	6,159	3,054
Cash flows from investing activities:		
Acquisition of real estate and related intangible assets	(3,718)	(5,650)
Improvements of existing real estate	(1,673)	(121)
Receipts from lenders for funds held in escrow	496	1,228
Payments to lenders for funds held in escrow	(1,260)	(830)
Receipts from tenants for reserves	790	1,456
Payments to tenants from reserves	(2,335)	(541)
Decrease (increase) in restricted cash	1,545	(915)
Deposits on future acquisitions	(250)	
Deposits applied against real estate investments	127	50
Net cash used in investing activities	(6,278)	(5,323)
Cash flows from financing activities:		
Proceeds from issuance of equity	7,707	6,484
Offering costs	(503)	(398)
Borrowings under mortgage notes payable		3,700

Payments for deferred financing costs		(360)		(141)
Principal repayments on mortgage notes payable		(2,172)		(1,808)
Principal repayments on employee notes receivable				35
Borrowings from line of credit		12,700		7,900
Repayments on line of credit		(13,000)		(6,500)
Distributions paid for common, senior common and preferred stock		(6,986)		(5,270)
Net cash (used in) provided by financing activities		(2,614)		4,002
Net (decrease) increase in cash and cash equivalents		(2,733)		1,733
Cash and cash equivalents, beginning of period		8,546		5,546
Cash and cash equivalents, end of period	$	5,813	$	7,279
NON-CASH OPERATING, INVESTING AND FINANCING INFORMATION				
Fixed rate debt assumed in connection with acquisitions	$	6,330	$	
Senior common dividend issued in the dividend reinvestment program	$	39	$	22
Capital improvements included in accounts payable	$	671	$	

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

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Gladstone Commercial Corporation

Notes to Consolidated Financial Statements (Unaudited)

1. Organization, Basis of Presentation and Significant Accounting Policies

Gladstone Commercial Corporation, is a real estate investment trust, or REIT, that was incorporated under the General Corporation Laws of the State of Maryland on February 14, 2003 primarily for the purpose of investing in and owning net leased industrial, commercial and retail real property and selectively making long-term industrial and commercial mortgage loans. Subject to certain restrictions and limitations, our business is managed by Gladstone Management Corporation, a Delaware corporation, or the Adviser, and administrative services are provided by Gladstone Administration, LLC, a Delaware limited liability company, or the Administrator, each pursuant to a contractual arrangement with us. Our Adviser and Administrator collectively employ all of our personnel and pay their salaries, benefits, and general expenses directly.

Subsidiaries

We conduct substantially all of our operations through a subsidiary, Gladstone Commercial Limited Partnership, a Delaware limited partnership, or the Operating Partnership. As we currently own all of the general and limited partnership interests of the Operating Partnership through two of our subsidiaries, GCLP Business Trust I and II, the financial position and results of operations of the Operating Partnership are consolidated with those of the Company.

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

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

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

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

Interim Financial Information

Our interim financial statements are prepared in accordance with accounting principles generally accepted in the United States of America, or GAAP, for interim financial information and pursuant to the requirements for reporting on Form 10-Q and in accordance with Article 10 of Regulation S-X. Accordingly, certain disclosures accompanying annual financial statements prepared in accordance with GAAP are omitted. The year-end balance sheet data presented herein was derived from audited financial

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statements, but does not include all disclosures required by GAAP. In the opinion of our management, all adjustments, consisting solely of normal recurring accruals, necessary for the fair presentation of financial statements for the interim period have been included. The interim financial statements and notes thereto should be read in conjunction with the financial statements and notes thereto included in our Form 10-K for the year ended December 31, 2013, as filed with the Securities and Exchange Commission on February 18, 2014. The results of operations for the three months ended March 31, 2014 are not necessarily indicative of the results that may be expected for other interim periods or for the full fiscal year.

Use of Estimates

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

Real Estate and Lease Intangibles

We record investments in real estate at cost and capitalize improvements and replacements when they extend the useful life or improve the efficiency of the asset. We expense costs of repairs and maintenance as such costs are incurred. We compute depreciation using the straight-line method over the estimated useful life or 39 years for buildings and improvements, 5 to 20 years for equipment and fixtures, and the shorter of the useful life or the remaining lease term for tenant improvements and leasehold interests.

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

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

We allocate purchase price to the fair value of the tangible assets of an acquired property by valuing the property as if it were vacant. The as-if-vacant value is allocated to land, building and tenant improvements based on management s determination of the relative fair values of these assets. Real estate depreciation expense on these tangible assets was $4.4 million and $3.4 million for the three months ended March 31, 2014 and 2013, respectively

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Above-market and below-market in-place lease fair values for owned properties are recorded based on the present value (using an interest rate which reflects the risks associated with the leases acquired) of the difference between (i) the contractual amounts to be paid pursuant to the in-place leases and (ii) management s estimate of fair market lease rates for the corresponding in-place leases, measured over a period equal to the remaining non-cancelable term of the lease. When determining the non-cancelable term of the lease, we evaluate if fixed-rate renewal options, if any, should be included. The capitalized above-market lease values, included in the accompanying condensed consolidated balance sheets as part of deferred rent receivable, are amortized as a reduction of rental income over the remaining non-cancelable terms of the respective leases. Total amortization related to above-market lease values was $0.1 million, for both the three months ended March 31, 2014 and 2013, respectively. The capitalized below-market lease values, included in the accompanying condensed consolidated balance sheets as part of deferred rent liability, are amortized as an increase to rental income over the remaining non-cancelable terms of the respective leases including any below market renewal periods. Total amortization related to below-market lease values was $0.2 million for both the three months ended March 31, 2014 and 2013, respectively.

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

The value of in-place leases and lease origination costs are amortized to expense over the remaining term of the respective leases, which generally range from 10 to 15 years. The value of customer relationship intangibles, which is the benefit to us resulting from the likelihood of an existing tenant renewing its lease, are amortized to expense over the remaining term and any anticipated renewal periods in the respective leases, but in no event does the amortization period for intangible assets exceed the remaining depreciable life of the building. Should a tenant terminate its lease, the unamortized portion of the above-market and below-market lease values would be charged to rental income and the unamortized portion of in-place lease values, lease origination costs and customer relationship intangibles will be immediately charged to amortization expense. Total amortization expense related to these intangible assets and liabilities was $2.3 million and $1.5 million for the three months ended March 31, 2014 and 2013, respectively.

Real Estate Held for Sale

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

Impairment Charges

We account for the impairment of real estate, including intangible assets, in accordance with ASC 360-10-35, Property, Plant, and Equipment, which requires us to periodically review the carrying value of each property to determine if circumstances indicate impairmen