

GLADSTONE COMMERCIAL CORP

Form 10-Q

July 31, 2007

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 JUNE 30, 2007
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, or a non-accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Large Accelerated Filer Accelerated Filer Non-Accelerated Filer .

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

The number of shares of the registrant's Common Stock, \$0.001 par value, outstanding as of July 27, 2007 was 8,565,264.

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

	June 30, 2007	December 31, 2006
ASSETS		
Real estate, net of accumulated depreciation of \$11,947,461 and \$8,595,419, respectively	\$ 280,541,611	\$ 235,118,123
Lease intangibles, net of accumulated amortization of \$5,877,604 and \$4,175,685, respectively	26,038,291	23,416,696
Mortgage notes receivable	10,000,000	10,000,000
Cash and cash equivalents	9,681,885	36,005,686
Restricted cash	1,469,750	1,225,162
Funds held in escrow	1,789,814	1,635,819
Interest receivable mortgage note	83,333	
Interest receivable employees	52,735	43,716
Deferred rent receivable	4,277,061	3,607,279
Deferred financing costs, net of accumulated amortization of \$1,800,471 and \$1,467,297, respectively	4,067,858	3,713,004
Prepaid expenses	456,354	521,290
Deposits on real estate	300,000	300,000
Accounts receivable	387,747	179,247
TOTAL ASSETS	\$ 339,146,439	\$ 315,766,022
 LIABILITIES AND STOCKHOLDERS EQUITY		
LIABILITIES		
Mortgage notes payable	\$ 182,124,367	\$ 154,494,438
Deferred rent liability	4,325,817	4,718,599
Asset retirement obligation liability	1,752,378	1,631,294
Accounts payable and accrued expenses	588,581	673,410
Due to adviser	682,481	183,042
Rent received in advance, security deposits and funds held in escrow	2,175,708	1,841,063
Total Liabilities	191,649,332	163,541,846
 STOCKHOLDERS EQUITY		
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, 17,700,000 shares authorized and 8,565,264 shares issued and outstanding	8,565	8,565
Additional paid in capital	170,640,979	170,640,979

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Notes receivable employees	(2,801,180)	(3,201,322)
Distributions in excess of accumulated earnings	(20,353,407)	(15,226,196)
Total Stockholders Equity	147,497,107	152,224,176
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	\$ 339,146,439	\$ 315,766,022

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

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GLADSTONE COMMERCIAL CORPORATION
CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)

	For the three months ended June		For the six months ended June	
	30,		30,	
	2007	2006	2007	2006
Operating revenues				
Rental income	\$ 7,732,322	\$ 6,027,830	\$ 14,810,358	\$ 10,894,906
Interest income from mortgage notes receivable	252,778	558,434	502,778	1,111,346
Tenant recovery revenue	94,468	43,798	150,203	49,420
Total operating revenues	8,079,568	6,630,062	15,463,339	12,055,672
 Operating expenses				
Depreciation and amortization	2,636,154	2,064,312	5,053,966	3,863,519
Base management fee (refer to Note 2)	471,091	719,392	953,135	1,372,134
Administration fee (refer to Note 2)	210,126		417,144	
Incentive fee (refer to Note 2)	633,805		1,219,573	
Professional fees	174,677	232,960	324,108	431,418
Taxes and licenses	50,178	39,069	65,185	89,963
Insurance	114,556	102,845	260,808	185,842
General and administrative	133,406	95,602	245,308	143,420
Directors fees	54,250	27,500	108,500	61,000
Stockholder related expenses	75,361	183,596	174,978	248,065
Asset retirement obligation expense	28,942	24,940	57,102	71,641
Stock option compensation expense		33,602		79,818
Total operating expenses before credit from Adviser	4,582,546	3,523,818	8,879,807	6,546,820
 Credit to incentive fee (Refer to Note 2)	 (633,805)		 (1,219,573)	
Total operating expenses	3,948,741	3,523,818	7,660,234	6,546,820
 Other income (expense)				
Interest income from temporary investments	63,269	4,057	292,285	11,431
Interest income employee loans	56,458	28,589	116,880	34,137
Other income	9,817	10,400	18,231	10,400
Interest expense	(2,702,612)	(2,155,968)	(5,217,073)	(3,774,536)
Total other expense	(2,573,068)	(2,112,922)	(4,789,677)	(3,718,568)

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Income from continuing operations	1,557,759	993,322	3,013,428	1,790,284
Discontinued operations				
(Loss) income from discontinued operations	(1,503)	71,215	(5,504)	109,253
Net realized income (loss) from foreign currency transactions	56	167	63	(649)
Net unrealized loss from foreign currency transactions		(211,939)		(199,323)
Taxes paid on sale of real estate			78,667	
Total discontinued operations	(1,447)	(140,557)	73,226	(90,719)
Net income	1,556,312	852,765	3,086,654	1,699,565
Dividends attributable to preferred stock	(1,023,437)	(484,375)	(2,046,874)	(828,819)
Net income available to common stockholders	\$ 532,875	\$ 368,390	\$ 1,039,780	\$ 870,746
Earnings per weighted average common share basic				
Income from continuing operations (net of dividends attributable to preferred stock)	\$ 0.06	\$ 0.07	\$ 0.11	\$ 0.12
Discontinued operations		(0.02)	0.01	(0.01)
Net income available to common stockholders	\$ 0.06	\$ 0.05	\$ 0.12	\$ 0.11
Earnings per weighted average common share diluted				
Income from continuing operations (net of dividends attributable to preferred stock)	\$ 0.06	\$ 0.06	\$ 0.11	\$ 0.12
Discontinued operations		(0.02)	0.01	(0.01)
Net income available to common stockholders	\$ 0.06	\$ 0.04	\$ 0.12	\$ 0.11
Weighted average shares outstanding				
Basic	8,565,264	7,762,503	8,565,264	7,717,501
Diluted	8,565,264	7,911,871	8,565,264	7,858,146

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

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GLADSTONE COMMERCIAL CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

	For the six months ended June 30,	
	2007	2006
Cash flows from operating activities:		
Net income	\$ 3,086,654	\$ 1,699,565
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization, including discontinued operations	5,053,966	3,915,819
Amortization of deferred financing costs, including discontinued operations	333,174	289,300
Amortization of deferred rent asset	126,748	126,748
Amortization of deferred rent liability	(392,782)	(303,478)
Asset retirement obligation expense, including discontinued operations	57,102	81,573
Increase in deferred rent receivable	(796,530)	(720,712)
Stock compensation		79,818
Increase in mortgage notes payable due to change in value of foreign currency		199,323
(Increase) decrease in mortgage interest receivable	(83,333)	3,609
Increase in employee interest receivable	(9,019)	(28,589)
(Increase) decrease in prepaid expenses and other assets	(143,564)	297,354
Increase in accounts payable, accrued expenses, and amount due adviser	414,610	65,606
Increase in rent received in advance	90,057	163,407
Net cash provided by operating activities	7,737,083	5,869,343
Cash flows from investing activities:		
Real estate investments	(53,035,069)	(40,506,626)
Principal repayments on mortgage notes receivable		44,742
Principal repayments on employee loans	400,142	
Net payments to lenders for reserves held in escrow	(868,679)	(1,899,416)
Increase in restricted cash	(244,588)	(412,074)
Deposits on future acquisitions	(810,000)	(500,000)
Deposits applied against real estate investments	810,000	1,100,000
Net cash used in investing activities	(53,748,194)	(42,173,374)
Cash flows from financing activities:		
Proceeds from share issuance		25,485,010
Offering costs		(1,302,004)
Borrowings under mortgage notes payable	28,015,000	31,900,000
Principal repayments on mortgage notes payable	(385,070)	(302,410)
Borrowings from line of credit	4,200,000	60,000,400
Repayments on line of credit	(4,200,000)	(73,900,400)
Increase in reserves from tenants	818,745	1,093,252
Increase in security deposits	140,525	562,500

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Payments for deferred financing costs	(688,025)	(1,650,237)
Dividends paid for common and preferred	(8,213,865)	(6,390,679)
Net cash provided by financing activities	19,687,310	35,495,432
Net decrease in cash and cash equivalents	(26,323,801)	(808,599)
Cash and cash equivalents, beginning of period	36,005,686	1,740,159
Cash and cash equivalents, end of period	\$ 9,681,885	\$ 931,560
NON-CASH INVESTING ACTIVITIES		
Increase in asset retirement obligation	\$ 121,084	\$ 1,510,330
NON-CASH FINANCING ACTIVITIES		
Fixed rate debt assumed in connection with acquisitions	\$	\$ 30,129,654
Notes receivable issued in exchange for common stock associated with the exercise of employee stock options	\$	\$ 1,826,754

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 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. Gladstone Commercial Partners, LLC transferred its 1% general partnership interest in the Operating Partnership to GCLP Business Trust II in exchange for 100 trust shares.

Interim financial information

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 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 and the value of tenant relationships, 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, including discontinued operations, was \$1,758,252 and \$3,352,047 for the three and six months ended June 30, 2007, respectively, and \$1,324,868 and \$2,478,984 for the three and six months ended June 30, 2006, 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 \$126,748 for the three and six months ended June 30, 2007, respectively, and \$63,374 and \$126,748 for the three and six months ended June 30, 2006, 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 \$392,782 for the three and six months ended June 30, 2007 respectively, and \$223,188 and \$303,479 for the three and six months ended June 30, 2006, 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 five to twenty 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 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 in-place lease value and customer relationship intangibles will be charged to expense. Total amortization expense related to these intangible assets, including discontinued operations, was \$877,902 and \$1,701,919 for the three and six months ended June 30, 2007, respectively, and \$756,204 and \$1,436,835 for the three and six months ended June 30, 2006, respectively.

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

	June 30, 2007		December 31, 2006	
	Lease Intangibles	Accumulated Amortization	Lease Intangibles	Accumulated Amortization
In-place leases	\$ 11,739,091	\$ (2,650,525)	\$ 10,738,319	\$ (1,907,668)
Leasing costs	6,689,195	(1,707,656)	5,891,099	(1,267,829)
Customer relationships	13,487,609	(1,519,423)	10,962,963	(1,000,188)
	\$ 31,915,895	\$ (5,877,604)	\$ 27,592,381	\$ (4,175,685)

The estimated aggregate amortization expense for the remainder of 2007 and each of the four succeeding fiscal years is as follows:

Year	Estimated Amortization Expense
2007	\$ 1,766,790
2008	3,533,580
2009	3,405,940
2010	3,214,175
2011	2,732,066

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 the Company's real estate assets at June 30, 2007.

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 commercial paper and money-market funds. All of the Compa