

GLADSTONE COMMERCIAL CORP
Form 10-Q
November 01, 2012

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, 2012

OR

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

FOR THE TRANSITION PERIOD FROM TO

COMMISSION FILE NUMBER: 001-33097

GLADSTONE COMMERCIAL CORPORATION

(Exact name of registrant as specified in its charter)

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MARYLAND
(State or other jurisdiction of
incorporation or organization)

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

1521 WESTBRANCH DRIVE, SUITE 200

MCLEAN, VIRGINIA
(Address of principal executive offices)

22102
(Zip Code)

(703) 287-5800

(Registrant's telephone number, including area code)

Not Applicable

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

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

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

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

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Large accelerated filer

Accelerated filer

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

Smaller reporting company

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

The number of shares of the registrant's Common Stock, \$0.001 par value, outstanding as of November 1, 2012 was 10,945,379.

GLADSTONE COMMERCIAL CORPORATION

FORM 10-Q FOR THE QUARTER ENDED

SEPTEMBER 30, 2012

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Gladstone Commercial Corporation

Condensed Consolidated Balance Sheets

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

(Unaudited)

	September 30, 2012	December 31, 2011
ASSETS		
Real estate, at cost	\$ 494,578	\$ 442,521
Less: accumulated depreciation	62,459	53,784
Total real estate, net	432,119	388,737
Lease intangibles, net	48,348	37,670
Cash and cash equivalents	14,782	3,329
Restricted cash	3,115	2,473
Funds held in escrow	6,207	4,086
Deferred rent receivable, net	13,484	12,403
Deferred financing costs, net	5,853	3,473
Other assets	1,736	976
TOTAL ASSETS	\$ 525,644	\$ 453,147
LIABILITIES AND STOCKHOLDERS EQUITY		
LIABILITIES		
Mortgage notes payable	\$ 337,931	\$ 285,350
Borrowings under line of credit	5,500	18,700
Series C mandatorily redeemable preferred stock, par value \$0.001 per share; \$25 per share liquidation preference; 1,700,000 shares and no shares authorized; and 1,540,000 shares and no shares issued and outstanding at September 30, 2012 and December 31, 2011, respectively	38,500	
Deferred rent liability, net	5,659	3,851
Asset retirement obligation liability	3,711	3,289
Accounts payable and accrued expenses	4,920	1,956
Due to Adviser and Administrator ⁽¹⁾	1,034	1,188
Other liabilities	4,382	3,499
Total Liabilities	401,637	317,833
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 September 30, 2012 and December 31, 2011, respectively	2	2
Senior common stock, par value \$0.001 per share; 7,500,000 shares authorized and 136,476 and 60,290 shares issued and outstanding at September 30, 2012 and December 31, 2011, respectively		
Common stock, par value \$0.001 per share, 38,500,000 shares authorized and 10,945,379 shares issued and outstanding at September 30, 2012 and December 31, 2011, respectively	11	11
Additional paid in capital	212,542	211,553
Notes receivable - employees	(410)	(422)
Distributions in excess of accumulated earnings	(88,138)	(75,830)

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Total Stockholders' Equity	124,007	135,314
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$ 525,644	\$ 453,147

(1) Refer to Note 2 Related-Party Transactions

(2) Refer to Note 7 Commitments and Contingencies

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

Gladstone Commercial Corporation

Condensed Consolidated Statements of Operations

(Dollars in Thousands, Except Per Share Data)

(Unaudited)

	For the three months ended September 30, 2012		For the nine months ended September 30, 2011	
	2012	2011	2012	2011
Operating revenues				
Rental income	\$ 12,878	\$ 11,085	\$ 37,214	\$ 32,249
Tenant recovery revenue	92	88	264	259
Total operating revenues	12,970	11,173	37,478	32,508
Operating expenses				
Depreciation and amortization	4,276	3,629	12,172	10,473
Property operating expenses	345	251	1,031	750
Due diligence expense	117	201	805	194
Base management fee ⁽¹⁾	355	430	1,120	1,217
Incentive fee ⁽¹⁾	927	877	2,614	2,549
Administration fee ⁽¹⁾	272	242	846	759
General and administrative	343	381	1,130	1,193
Total operating expenses before credits from Adviser	6,635	6,011	19,718	17,135
Credit to incentive fee ⁽¹⁾	(535)	(828)	(1,794)	(1,759)
Total operating expenses	6,100	5,183	17,924	15,376
Other income (expense)				
Interest expense	(5,229)	(4,251)	(14,687)	(12,607)
Distributions attributable to mandatorily redeemable preferred stock	(686)		(1,829)	
Other income	37	9	109	73
Total other expense	(5,878)	(4,242)	(16,407)	(12,534)
Net income	992	1,748	3,147	4,598
Distributions attributable to preferred stock	(1,023)	(1,023)	(3,070)	(3,070)
Distributions attributable to senior common stock	(30)	(16)	(71)	(46)
Net (loss) income available to common stockholders	\$ (61)	\$ 709	\$ 6	\$ 1,482
Earnings per weighted average share of common stock - basic & diluted				
(Loss) income from continuing operations (net of dividends attributable to preferred stock)	\$ (0.01)	\$ 0.07	\$ 0.00	\$ 0.15
Net (loss) income available to common stockholders	\$ (0.01)	\$ 0.07	\$ 0.00	\$ 0.15
Weighted average shares of common stock outstanding				
Basic	10,945	10,936	10,945	9,998

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Diluted	10,945	10,988	11,023	10,050
Earnings per weighted average share of senior common stock	\$ 0.26	\$ 0.26	\$ 0.80	\$ 0.78
Weighted average shares of senior common stock outstanding - basic	112	59	89	59

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

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

Gladstone Commercial Corporation

Condensed Consolidated Statements of Cash Flows

(Dollars in Thousands)

(Unaudited)

	For the nine months ended September 30,	
	2012	2011
Cash flows from operating activities:		
Net income	\$ 3,147	\$ 4,598
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	12,172	10,473
Amortization of deferred financing costs	1,103	684
Amortization of deferred rent asset and liability, net	(533)	(513)
Amortization of discount and premium on assumed debt	45	78
Asset retirement obligation expense	124	116
Increase in other assets	(261)	(396)
Increase in deferred rent liability	2,510	1,626
Increase in deferred rent receivable	(1,189)	(1,051)
Increase (decrease) in accounts payable, accrued expenses, and amount due Adviser	2,810	(1,641)
Increase in other liabilities	240	430
Leasing commissions paid	(1,538)	
Net cash provided by operating activities	18,630	14,404
Cash flows from investing activities:		
Real estate investments	(52,833)	(16,333)
Receipts from lenders for funds held in escrow	1,286	1,329
Payments to lenders for funds held in escrow	(3,406)	(2,759)
Receipts from tenants for reserves	2,156	1,649
Payments to tenants from reserves	(1,647)	(1,320)
Increase in restricted cash	(642)	(279)
Deposits on future acquisitions	(500)	(900)
Deposits refunded		250
Net cash used in investing activities	(55,586)	(18,363)
Cash flows from financing activities:		
Proceeds from issuance of equity	1,103	39,657
Offering costs	(125)	(2,407)
Proceeds from issuance of mandatorily redeemable preferred stock	38,500	
Borrowings under mortgage notes payable	46,455	
Payments for deferred financing costs	(3,483)	(478)
Principal repayments on mortgage notes payable	(5,544)	(5,585)
Principal repayments on employee notes receivable	12	537
Borrowings from line of credit	19,300	39,374
Repayments on line of credit	(32,500)	(57,274)
Increase (decrease) in security deposits	134	(50)
Distributions paid for common, senior common and preferred stock	(15,443)	(14,467)
Net cash provided by (used in) financing activities	48,409	(693)
Net increase (decrease) in cash and cash equivalents	11,453	(4,652)
Cash and cash equivalents, beginning of period	3,329	7,062

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Cash and cash equivalents, end of period	\$	14,782	\$	2,410
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NON-CASH OPERATING, INVESTING AND FINANCING INFORMATION

Fixed rate debt assumed in connection with acquisitions	\$	10,758	\$	11,921
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Senior common dividend issued in the dividend reinvestment program	\$	11		
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The accompanying notes are an integral part of these condensed consolidated financial statements.

Gladstone Commercial Corporation

Notes to Condensed Consolidated Financial Statements (Unaudited)

1. Organization and Significant Accounting Policies

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

Subsidiaries

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

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

Gladstone Commercial Advisers, Inc., a Delaware corporation (*Commercial Advisers*) and a subsidiary of the *Company*, is a taxable REIT subsidiary (*TRS*), which was created to collect 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.

Interim Financial Information

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

Out of Period Adjustment

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

Use of Estimates

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

Reclassifications

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

Real Estate and Lease Intangibles

We record investments in real estate at cost and capitalize improvements and replacements when they extend the useful life or improve the efficiency of the asset. We expense costs of repairs and maintenance as such costs are incurred. We compute depreciation using the straight-line method over the estimated useful life or 39 years for buildings and improvements, 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.

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

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

We allocate purchase price to the fair value of the tangible assets of an acquired property by valuing the property as if it were vacant. The as-if-vacant value is allocated to land, building and tenant improvements based on management's determination of the relative fair values of these assets. Real estate depreciation expense on these tangible assets was \$3.0 million and \$8.7 million for the three and nine months ended September 30, 2012, respectively, and \$2.6 million and \$7.5 million for the three and nine months ended September 30, 2011, respectively.

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

management's estimate of fair market lease rates for the corresponding in-place leases, measured over a period equal to the remaining non-cancelable term of the lease. When determining the non-cancelable term of the lease, we evaluate if fixed-rate renewal options, if any, should be included. The capitalized above-market lease values, included in the accompanying balance sheet as part of deferred rent receivable, are amortized as a reduction of rental income over the remaining non-cancelable terms of the respective leases. Total amortization related to above-market lease values was \$0.1 million and \$0.3 million for the three and nine months ended September 30, 2012, respectively, and \$0.1 million and \$0.2 million for the three and nine months ended September 30, 2011, respectively. The capitalized below-market lease values, included in the accompanying condensed consolidated balance sheets as part of deferred rent liability, are amortized as an increase to rental income over the remaining non-cancelable terms of the respective leases. Total amortization related to below-market lease values was \$0.3 million and \$0.8 million for both the three and nine months ended September 30, 2012 and 2011, respectively.

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

The value of in-place leases and unamortized lease origination costs are amortized to expense over the remaining term of the respective leases, which generally range from 10 to 15 years. The value of customer relationship intangibles, which is the benefit to us resulting from the likelihood of an existing tenant renewing its lease, are amortized to expense over the remaining term and any anticipated renewal periods in the respective leases, but in no event does the amortization period for intangible assets exceed the remaining depreciable life of the building. Should a tenant terminate its lease, the unamortized portion of the above-market and below-market lease values, in-place lease values, unamortized lease origination costs and customer relationship intangibles will be immediately charged to the related income or expense. Total amortization expense related to these intangible assets was \$1.2 million and \$3.5 million for the three and nine months ended September 30, 2012, respectively, and \$1.0 million and \$3.0 million for the three and nine months ended September 30, 2011, respectively.

Impairment

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

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

Deferred Financing Costs

Deferred financing costs consist of costs incurred to obtain financing, including legal fees, origination fees and administrative fees. The costs are deferred and amortized using the straight-line method, which approximates the effective interest method, over the term of the secured financing. We made payments of \$0.5 million and \$3.5 million for deferred financing costs during the three and nine months ended September 30, 2012, respectively, and \$0.3 million and \$0.5 million for the three and nine months ended September 30, 2011, respectively. The payments incurred during the nine months ended September 30, 2012 were primarily related to the issuance of our 7.125% Series C Cumulative Term Preferred Stock, (the Term Preferred Stock), discussed in further detail in Note 6 Mandatorily Redeemable Preferred Stock. Total amortization expense related to deferred financing costs is included in interest expense and was \$0.4 million and \$1.1 million for the three and nine months ended September 30, 2012, respectively, and \$0.2 million and \$0.7 million for the three and nine months ended September 30, 2011, respectively.

Revenue Recognition

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

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

Asset Retirement Obligations

ASC 410, Asset Retirement and Environmental Obligation, requires an entity to recognize a liability for a conditional asset retirement obligation when incurred if the liability can be reasonably estimated. ASC 410-20-20 clarifies that the term Conditional Asset Retirement Obligation refers to a legal obligation (pursuant to existing laws or by contract) to perform an asset retirement activity in which the timing and/or method of settlement are conditional on a future event that may or may not be within the control of the entity. ASC 410-20-25-6 clarifies when an entity would have sufficient information to reasonably estimate the fair value of an asset retirement obligation. We have accrued a liability and corresponding increase to the cost of the related properties for disposal related to all properties constructed prior to 1985 that have, or may have, asbestos present in the building. The liabilities are accreted over the life of the leases for the respective properties. There was \$0.3 million in liabilities accrued in connection with acquisitions for the nine months ended September 30, 2012. There were no liabilities accrued during the nine months ended September 30, 2011, as the properties acquired during this period were constructed after 1985. The Company also recorded expenses of \$43 and \$124 during the three and nine months ended September 30, 2012 respectively, and \$39 and \$116 during the three and nine months ended September 30, 2011, respectively, related to the accretion of the obligation. Costs of future expenditures for obligations are discounted to their present value. The aggregate undiscounted obligation on all properties is \$9.2 million and the discount rates used in the calculations ranges from 2.5% to 7.6%. The Company does not expect to make any payments in conjunction with these obligations in each of the next five years.

Comprehensive Income

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

Recent Accounting Pronouncements

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

2. Related-Party Transactions

We are externally managed pursuant to contractual arrangements with our Adviser and Gladstone Administration, LLC (the Administrator), which collectively employ all of our personnel and pays their salaries, benefits, and general expenses directly. We have an advisory agreement with our Adviser (the Advisory Agreement) and an administration agreement with our Administrator (the Administration Agreement). The management and administrative services and fees under the Advisory and Administration Agreements are described below. As of September 30, 2012 and December 31, 2011, respectively, \$1.0 million and \$1.2 million were due to the Adviser and Administrator.

Advisory Agreement

The Advisory Agreement provides for an annual base management fee equal to 2% of our total stockholders' equity, less the recorded value of any preferred stock (common stockholders' equity), and an incentive fee based on funds from operations (FFO). For the three and nine months ended September 30, 2012, we recorded a base management fee of \$0.4 million and \$1.1 million, respectively, and for the three and nine months ended September 30, 2011, we recorded a base management fee of \$0.4 million and \$1.2 million, respectively.

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

For the three and nine months ended September 30, 2012, we recorded an incentive fee of \$0.9 million and \$2.6 million, respectively, offset by a credit related to an unconditional, voluntary and irrevocable waiver issued by the Adviser of \$0.5 million and \$1.8 million, respectively, resulting in a net incentive fee for the three and nine months ended September 30, 2012, of \$0.4 million and \$0.8 million, respectively. For the three and nine months ended September 30, 2011, we recorded an incentive fee of \$0.9 million and \$2.6 million, respectively, offset by a credit related to an unconditional and irrevocable voluntary waiver issued by the Adviser of \$0.8 million and \$1.8 million, respectively, resulting in a net incentive fee for the three and nine months ended September 30, 2011, of \$0.1 million and \$0.8 million, respectively. Our Board of Directors accepted the Adviser's offer to waive, on a quarterly basis, a portion of the incentive fee for the three and nine months ended September 30, 2012 and 2011, in order to support the current level of distributions to our stockholders. This waiver may not be recouped by the Adviser in the future.

Administration Agreement

Pursuant to the Administration Agreement, we pay for our allocable portion of the Administrator's overhead expenses in performing its obligations to us, including, but not limited to, rent and the salaries and benefits of its personnel, including our chief financial officer and treasurer, chief compliance officer, internal counsel, investor relations department and their respective staffs. Our allocable portion of expenses is derived by multiplying the Administrator's total allocable expenses by the percentage of our total assets at the beginning of each quarter in comparison to the total assets of all companies managed by the Adviser under similar agreements. For the three and nine months ended September 30, 2012, we recorded an administration fee of \$0.3 million and \$0.8 million, respectively, and for the three and nine months ended September 30, 2011, we recorded an administration fee of \$0.2 million and \$0.8 million, respectively.

Dealer Manager Agreement

In connection with the offering of our senior common stock (see Note 8, "Stockholders' Equity," for further details) we entered into a Dealer Manager Agreement, dated March 25, 2011 (the "Dealer Manager Agreement"), with Gladstone Securities, LLC (the "Dealer Manager"), pursuant to which the Dealer Manager agreed to act as our exclusive dealer manager in connection with the offering. The Dealer Manager is an affiliate of ours, as its parent company is controlled by Mr. David Gladstone, our Chairman and chief executive officer. Pursuant to the terms of the Dealer Manager Agreement, the Dealer Manager is entitled to receive a sales commission in the amount of 7.0% of the gross proceeds of the shares of senior common stock sold, plus a dealer manager fee in the amount of 3.0% of the gross proceeds of the shares of senior common stock sold. The Dealer Manager, in its sole and absolute discretion, may re-allocate all of its selling commissions attributable to a participating broker-dealer and may also re-allocate a portion of its Dealer Manager fee earned in respect of the proceeds generated by the participating broker-dealer to any participating broker-dealer as a non-accountable marketing allowance. In addition, we have agreed to indemnify the Dealer Manager against various liabilities, including certain liabilities arising under the federal securities laws. We made \$49 and \$99 of payments during the three and nine months ended September 30, 2012, respectively, to the Dealer Manager pursuant to this agreement. There were no payments made during the three and nine months ended September 30, 2011.

3. Earnings per Share of Common Stock

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

	For the three months ended September 30,		For the nine months ended September 30,	
	2012	2011	2012	2011
Calculation of basic earnings per share of common stock:				
Net (loss) income available to common stockholders	\$ (61)	\$ 709	\$ 6	\$ 1,482
Denominator for basic weighted average shares of common stock (in thousands)	10,945	10,936	10,945	9,998
Basic (loss) earnings per share of common stock	\$ (0.01)	\$ 0.07	\$ 0.00	\$ 0.15
Calculation of diluted earnings per share of common stock:				
Net (loss) income available to common stockholders	\$ (61)	\$ 709	\$ 6	\$ 1,482
Add: Income impact of assumed conversion of senior common stock		16	71	46
Net (loss) income available to common stockholders plus assumed conversions	\$ (61)	\$ 725	\$ 77	\$ 1,528
Denominator for basic weighted average shares of common stock (in thousands)	10,945	10,936	10,945	9,998
Effect of convertible senior common stock (in thousands)	(1)	52	78	52
Denominator for diluted weighted average shares of common stock (in thousands)	10,945	10,988	11,023	10,050
Diluted (loss) earnings per share of common stock	\$ (0.01)	\$ 0.07	\$ 0.01	\$ 0.15

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

4. Real Estate and Intangible Assets

Real Estate

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

	September 30, 2012	December 31, 2011
Real estate:		
Land	\$ 66,258	\$ 60,602
Building and improvements	409,167	367,605
Tenant improvements	19,153	14,314
Accumulated depreciation	(62,459)	(53,784)
Real estate, net	\$ 432,119	\$ 388,737

New Real Estate Activity

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

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Location	Acquisition Date	Square Footage	Lease		Total Purchase Price	Acquisition Expenses	Annualized Line Rent	Straight Debt Issued / Assumed
			Term	Renewal Options				
Ashburn, VA	1/25/2012	52,130	15 years	2 (5 years each)	\$ 10,775	\$ 102	\$ 989	N/A
Ottumwa, IA	5/30/2012	352,860	11.5 years	3 (5 years each)	7,100	47	684	5,000
New Albany, OH	6/5/2012	89,000	10.5 years	2 (5 years each)	13,333	188	1,361	N/A
Columbus, GA	6/21/2012	32,000	11.5 years	2 (5 years each)	7,320	126	656	4,750
Columbus, OH	6/28/2012	31,293	10 years	N/A	4,037	59	342	N/A
Jupiter, FL	9/26/2012	60,000	10.5 years	2 (5 years each)	15,500	55	1,372	10,758

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

	Land	Building	Tenant Improvements	In-place Leases	Leasing Costs	Customer Relationships	Above Market Leases	Below Market Leases	Discount on Assumed Debt	Total Purchase Price
Ashburn, VA	\$ 706	\$ 6,551	\$ 1,307	\$ 804	\$ 908	\$ 499	\$	\$	\$	\$ 10,775
Ottumwa, IA	212	4,743	329	940	484	499		(107)		7,100
New Albany, OH	1,658	7,511	1,235	1,122	857	903	47			13,333
Columbus, GA	1,378	3,894	626	574	473	375				7,320
Columbus, OH	542	1,856	597	391	213	325	113			4,037
Jupiter, FL	1,160	11,249	745	1,603	701	909			(867)	15,500
	\$ 5,656	\$ 35,804	\$ 4,839	\$ 5,434	\$ 3,636	\$ 3,510	\$ 160	\$ (107)	\$ (867)	\$ 58,065

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

Location	Acquisition Date	Rental Revenue		Net Income	
		For the three months ended September 30, 2012	For the nine months ended September 30, 2012	For the three months ended September 30, 2012 ⁽¹⁾	For the nine months ended September 30, 2012 ⁽¹⁾
Ashburn, VA	1/25/2012	\$ 247	\$ 678	\$ 147	\$ 409
Ottumwa, IA	5/30/2012	173	235	85	116
New Albany, OH	6/5/2012	339	437	197	248
Columbus, GA	6/21/2012	164	182	88	98
Columbus, OH	6/28/2012	83	86	31	34
Jupiter, FL	9/26/2012	19	19	10	10
		\$ 1,025	\$ 1,637	\$ 558	\$ 915

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

We acquired six properties during the nine months ended September 30, 2012. The following table reflects pro-forma condensed consolidated statements of operations as if the properties were acquired as of the beginning of the earliest periods presented, which was January 1, 2011. The pro-forma earnings for the three and nine months ended September 30, 2012, were adjusted to exclude \$0.6 million of acquisition-related costs incurred in 2012 related to the six properties acquired. The pro-forma earnings for the three and nine months ended September 30, 2011, were adjusted to include these charges:

	For the three months ended September 30,		For the nine months ended September 30,	
	2012	2011	2012	2011
Operating Data:				
Total operating revenue	\$ 13,294	\$ 12,520	\$ 39,862	\$ 36,521
Total operating expenses	(6,161)	(5,971)	(18,804)	(18,304)
Other expense	(5,948)	(4,735)	(17,350)	(14,013)
Net income	1,185	1,814	3,708	4,204
Dividends attributable to preferred and senior common stock	(1,053)	(1,039)	(3,141)	(3,117)
Net income available to common stockholders	\$ 132	\$ 775	\$ 567	\$ 1,087

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Share and Per Share Data:

Basic earnings per share of common stock	\$ 0.01	\$ 0.07	\$ 0.05	\$ 0.11
Diluted earnings per share of common stock	\$ 0.01	\$ 0.07	\$ 0.05	\$ 0.11
Weighted average shares outstanding-basic	10,945	10,936	10,945	9,998
Weighted average shares outstanding-diluted	11,039	10,988	11,023	10,050

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

Intangible assets & liabilities	Years
In-place leases	10.7
Leasing costs	10.7
Customer relationships	15.1
Above market leases	10.1
Below market leases	11.3
 All intangible assets & liabilities	 12.1

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

Year	Tenant Lease Payments
Three months ending December 31, 2012	\$ 12,318
2013	48,041
2014	44,784
2015	40,920
2016	36,514
2017	34,232
Thereafter	217,580

In accordance with the lease terms, substantially all tenant expenses are required to be paid by the tenant; however, we would be required to pay property taxes on the respective properties in the event the tenants fail to pay them. The total annualized property taxes for all properties owned by us at September 30, 2012, were \$8.2 million.

Existing Real Estate Activity

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

On February 27, 2012, we extended the lease with the tenant occupying our property located in Roseville, Minnesota. The new lease covers approximately one-third of this property and was extended for an additional five-year period, through December 2017. The lease was originally set to expire in December 2012. The tenant in this property will pay rent on the entire building through the end of 2012, and we continue to search for new tenants to lease the remainder of the building. The new lease provides for prescribed rent escalations over the life of the lease, with annualized straight line rents of \$2.9 million for the remainder of 2012 and annualized straight line rents beginning in 2013 of \$1.2 million. Furthermore, the lease grants the tenant one option to extend the lease for a period of five years. In connection with the extension of the lease and the modification of certain terms under the lease, we provided a tenant allowance of \$0.4 million, payable over two years, and paid \$0.8 million in leasing commissions.

On June 25, 2012, we extended the lease with the tenant occupying our property located in Hialeah, Florida. The lease covering this property was extended for an additional five-year period, through March 2027. The lease was originally set to expire in March 2022. The lease provides for prescribed rent escalations over the life of the lease, with annualized straight line rents of approximately \$1.1 million. In connection with the extension of the lease and the modification of certain terms under the lease, we provided a tenant allowance of \$0.3 million.

On August 7, 2012, we extended the lease with the tenant occupying our property located in Wichita, Kansas. The lease covering this property was extended for an additional five-year period, through September 2017. The lease was originally set to expire in September 2012. The lease provides for prescribed rent escalations over the life of the lease, with annualized straight line rents of approximately \$0.8 million. In connection with the extension of the lease and the modification of certain terms under the lease, we paid \$0.2 million in leasing commissions.

On September 10, 2012, we extended the lease with the tenant occupying our property located in South Hadley, Massachusetts. The lease covering this property was extended for an additional one-year period, through January 2014. The lease was originally set to expire in February 2013. The lease provides for annual rents of approximately \$0.3 million.

On September 11, 2012, we extended the lease with the tenant occupying our property located in Mason, Ohio. The lease covering this property was extended for almost an additional seven-year period, through June 2020. The lease was originally set to expire in January 2013. The lease provides for prescribed rent escalations over the life of the lease, with annualized straight line rents of approximately \$0.6 million. In connection with the extension of the lease and the modification of certain terms under the lease, we provided a tenant allowance of \$0.5 million, and paid \$0.3 million in leasing commissions.

On September 27, 2012, our tenant occupying our property located in Arlington, Texas, exercised its option to extend the lease covering this property for an additional five-year period, through March 2018. The lease was originally set to expire in April 2013. The lease provides that the option period rent be at fair market rent, but not less than the current rental rate.

Intangible Assets

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

	September 30, 2012		December 31, 2011	
	Lease Intangibles	Accumulated Amortization	Lease Intangibles	Accumulated Amortization
In-place leases	\$ 30,052	\$ (11,577)	\$ 24,620	\$ (10,181)
Leasing costs	20,245	(6,676)	15,013	(5,663)
Customer relationships	24,236	(7,932)	20,725	(6,844)
	\$ 74,533	\$ (26,185)	\$ 60,358	\$ (22,688)

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

Year	Estimated Amortization Expense
Three months ending December 31, 2012	1,803
2013	6,015
2014	5,352
2015	4,938
2016	4,323
2017	4,144
Thereafter	21,773

5. Mortgage Notes Payable and Line of Credit

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

	Date of Issuance/ Assumption	Principal Maturity Date	Stated Interest Rate at September 30, 2012 (1)	Principal Balance Outstanding	
				September 30, 2012	December 31, 2011
Fixed-Rate Mortgage Notes Payable:	09/15/08	10/01/12 ⁽²⁾	4.76%	\$ 45,233	\$ 45,233
	02/21/06	12/01/13	5.91%	8,707	8,845
	02/21/06	06/30/14	5.20%	18,037	18,345
	08/25/05	09/01/15	5.33%	20,167	20,431
	09/12/05	09/01/15	5.21%	11,872	12,019
	12/21/05	12/08/15	5.71%	18,231	18,448
	09/06/07	12/11/15	5.81%	4,161	4,219
	03/29/06	04/01/16	5.92%	16,722	16,871
	04/27/06	05/05/16	6.58%	13,166	13,409
	08/29/08	06/01/16	6.80%	5,905	6,019
	06/20/11	06/30/16	6.08%	11,384	11,505
	11/22/06	12/01/16	5.76%	13,611	13,761