

GLADSTONE COMMERCIAL CORP

Form 10-Q

October 31, 2016

Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2016

OR

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

FOR THE TRANSITION PERIOD FROM _____ TO _____

COMMISSION FILE NUMBER: 001-33097

GLADSTONE COMMERCIAL CORPORATION

(Exact name of registrant as specified in its charter)

MARYLAND

(State or other jurisdiction of
incorporation or organization)

02-0681276

(I.R.S. Employer
Identification No.)

1521 WESTBRANCH DRIVE, SUITE 100
MCLEAN, VIRGINIA

(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 ☒ No ☐

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

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

Large accelerated filer ☐

Accelerated filer

☒

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

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

The number of shares of the registrant's Common Stock, \$0.001 par value, outstanding as of October 31, 2016 was 23,748,303.

Table of Contents

GLADSTONE COMMERCIAL CORPORATION
FORM 10-Q FOR THE QUARTER ENDED
September 30, 2016
TABLE OF CONTENTS

	PAGE
<u>PART I FINANCIAL INFORMATION</u>	
<u>Item 1. Financial Statements (Unaudited)</u>	
<u>Condensed Consolidated Balance Sheets as of September 30, 2016 and December 31, 2015</u>	<u>3</u>
<u>Condensed Consolidated Statements of Operations for the three and nine months ended September 30, 2016 and 2015</u>	<u>4</u>
<u>Condensed Consolidated Statements of Cash Flows for the nine months ended September 30, 2016 and 2015</u>	<u>5</u>
<u>Notes to Condensed Consolidated Financial Statements</u>	<u>6</u>
<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	<u>26</u>
<u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u>	<u>43</u>
<u>Item 4. Controls and Procedures</u>	<u>44</u>
<u>PART II OTHER INFORMATION</u>	
<u>Item 1. Legal Proceedings</u>	<u>45</u>
<u>Item 1A. Risk Factors</u>	<u>45</u>
<u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>	<u>45</u>
<u>Item 3. Defaults Upon Senior Securities</u>	<u>45</u>
<u>Item 4. Mine Safety Disclosures</u>	<u>45</u>
<u>Item 5. Other Information</u>	<u>45</u>
<u>Item 6. Exhibits</u>	<u>46</u>
<u>SIGNATURES</u>	<u>48</u>

Table of Contents

PART I – FINANCIAL INFORMATION

Item 1. Financial Statements

Gladstone Commercial Corporation

Condensed Consolidated Balance Sheets

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

(Unaudited)

	September 30, 2016	December 31, 2015
ASSETS		
Real estate, at cost	\$797,115	\$780,377
Less: accumulated depreciation	125,250	112,243
Total real estate, net	671,865	668,134
Lease intangibles, net	102,765	104,914
Real estate and related assets held for sale, net	11,748	1,077
Mortgage note receivable	—	5,900
Cash and cash equivalents	8,747	5,152
Restricted cash	4,002	4,205
Funds held in escrow	7,172	7,534
Deferred rent receivable, net	29,288	27,443
Other assets	3,056	2,825
TOTAL ASSETS	\$838,643	\$827,184
LIABILITIES, MEZZANINE EQUITY AND STOCKHOLDERS' EQUITY		
LIABILITIES		
Mortgage notes payable, net	\$444,522	\$455,863
Borrowings under Line of Credit, net	46,772	44,591
Borrowings under Term Loan Facility, net	24,892	24,878
Series C mandatorily redeemable term preferred stock, net, par value \$0.001 per share; \$25 per share liquidation preference; 160,000 and 1,700,000 shares authorized; and 0 and 1,540,000 shares issued and outstanding at September 30, 2016 and December 31, 2015, respectively	—	38,100
Deferred rent liability, net	11,275	9,657
Asset retirement obligation	3,268	3,674
Accounts payable and accrued expenses	4,031	6,388
Liabilities related to assets held for sale, net	688	868
Due to Adviser and Administrator (1)	1,991	1,858
Other liabilities	8,076	7,436
TOTAL LIABILITIES	\$545,515	\$593,313
Commitments and contingencies (2)		
MEZZANINE EQUITY		
Series D redeemable preferred stock, net, par value \$0.001 per share; \$25 per share liquidation preference; 6,000,000 and 0 shares authorized; and 2,775,589 and 0 shares issued and outstanding at September 30, 2016 and December 31, 2015, respectively (3)	\$67,213	\$—
TOTAL MEZZANINE EQUITY	\$67,213	\$—
STOCKHOLDERS' EQUITY		
Series A and B redeemable preferred stock, par value \$0.001 per share; \$25 per share liquidation preference; 5,350,000 and 2,300,000 shares authorized and 2,264,000 and 2,150,000 shares issued and outstanding at September 30, 2016 and December 31, 2015, respectively	\$2	\$2
Senior common stock, par value \$0.001 per share; 4,450,000 and 7,500,000 shares authorized and 959,552 and 972,214 shares issued and outstanding at September 30, 2016 and December	1	1

31, 2015, respectively

Common stock, par value \$0.001 per share, 34,040,000 and 38,500,000 shares authorized and 23,601,153 and 22,485,607 shares issued and outstanding at September 30, 2016 and

24 22

December 31, 2015, respectively

Additional paid in capital

440,136 418,897

Distributions in excess of accumulated earnings

(214,248) (185,051)

TOTAL STOCKHOLDERS' EQUITY

225,915 233,871

TOTAL LIABILITIES, MEZZANINE EQUITY AND STOCKHOLDERS' EQUITY

\$838,643 \$827,184

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

(2)Refer to Note 9 "Commitments and Contingencies"

(3)Refer to Note 10 "Stockholders' Equity and Mezzanine Equity"

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

Table of Contents

Gladstone Commercial Corporation
Condensed Consolidated Statements of Operations
(Dollars in Thousands, Except Share and Per Share Data)
(Unaudited)

	For the three months ended September 30,		For the nine months ended September 30,	
	2016	2015	2016	2015
Operating revenues				
Rental revenue	\$21,205	\$20,653	\$62,752	\$59,953
Tenant recovery revenue	384	437	1,226	1,195
Interest income from mortgage note receivable	—	285	385	835
Total operating revenues	21,589	21,375	64,363	61,983
Operating expenses				
Depreciation and amortization	9,459	9,006	27,796	26,160
Property operating expenses	1,410	1,612	4,455	3,752
Acquisition related expenses	149	138	275	589
Base management fee (1)	1,072	872	2,789	2,589
Incentive fee (1)	564	621	1,837	4,054
Administration fee (1)	311	326	1,086	1,054
General and administrative	421	446	1,607	1,675
Impairment charge	1,786	622	2,016	622
Total operating expenses before credit to incentive fee	15,172	13,643	41,861	40,495
Credit to incentive fee (1)	—	—	—	(2,500)
Total operating expenses	15,172	13,643	41,861	37,995
Other (expense) income				
Interest expense	(6,338)	(7,142)	(19,648)	(20,912)
Distributions attributable to Series C mandatorily redeemable preferred stock	(131)	(686)	(1,502)	(2,057)
Loss on sale of real estate	(24)	—	(24)	—
Other income	3	—	337	11
Total other expense, net	(6,490)	(7,828)	(20,837)	(22,958)
Net (loss) income	(73)	(96)	1,665	1,030
Distributions attributable to Series A, B and D preferred stock	(2,002)	(1,023)	(4,292)	(3,070)
Distributions attributable to senior common stock	(254)	(263)	(758)	(748)
Net loss attributable to common stockholders	\$(2,329)	\$(1,382)	\$(3,385)	\$(2,788)
Loss per weighted average share of common stock - basic & diluted				
Loss attributable to common shareholders	\$(0.10)	\$(0.06)	\$(0.15)	\$(0.13)
Weighted average shares of common stock outstanding				
Basic	23,509,054	21,403,808	22,915,086	20,820,559
Diluted	23,509,054	21,403,808	22,915,086	20,820,559
Earnings per weighted average share of senior common stock	\$0.26	\$0.26	\$0.79	\$0.79
Weighted average shares of senior common stock outstanding - basic	959,552	993,069	961,041	948,347

(1) Refer to Note 2 “Related-Party Transactions”

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

Table of Contents

Gladstone Commercial Corporation
Condensed Consolidated Statements of Cash Flows
(Dollars in Thousands)
(Unaudited)

	For the nine months ended September 30,	
	2016	2015
Cash flows from operating activities:		
Net income	\$1,665	\$1,030
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	27,796	26,160
Impairment charge	2,016	622
Loss on sale of real estate	24	—
Amortization of deferred financing costs	1,537	1,358
Amortization of deferred rent asset and liability, net	(363)	(394)
Amortization of discount and premium on assumed debt	(145)	(231)
Asset retirement obligation expense	114	114
Decrease (increase) in other assets	288	(946)
Increase in deferred rent receivable	(2,780)	(3,034)
Increase in accounts payable, accrued expenses, and amount due Adviser and Administrator	240	1,045
Increase (decrease) in other liabilities	51	(315)
Leasing commissions paid	(628)	(532)
Net cash provided by operating activities	29,815	24,877
Cash flows from investing activities:		
Acquisition of real estate and related intangible assets	(40,900)	(71,248)
Improvements of existing real estate	(3,793)	(4,969)
Proceeds from sale of real estate	3,022	—
Issuance of mortgage note receivable	—	(300)
Collection of mortgage note receivable	5,900	—
Receipts from lenders for funds held in escrow	2,747	2,952
Payments to lenders for funds held in escrow	(2,385)	(2,792)
Receipts from tenants for reserves	2,678	3,068
Payments to tenants from reserves	(2,219)	(1,992)
Decrease (increase) in restricted cash	203	(1,214)
Deposits on future acquisitions	(1,750)	(1,700)
Deposits applied against acquisition of real estate investments	1,250	1,700
Net cash used in investing activities	(35,247)	(76,495)
Cash flows from financing activities:		
Proceeds from issuance of equity	90,999	39,495
Offering costs paid	(2,367)	(892)
Retirement of senior common stock	(178)	—
Redemption of Series C mandatorily redeemable preferred stock	(38,500)	—
Borrowings under mortgage notes payable	56,005	61,059
Payments for deferred financing costs	(1,024)	(1,157)
Principal repayments on mortgage notes payable	(67,119)	(37,216)
Principal repayments on employee notes receivable	—	375
Borrowings from line of credit	132,500	73,200
Repayments on line of credit	(130,500)	(61,000)

Edgar Filing: GLADSTONE COMMERCIAL CORP - Form 10-Q

Increase in security deposits	73	138
Distributions paid for common, senior common and preferred stock	(30,862)	(27,253)
Net cash provided by financing activities	9,027	46,749
Net increase (decrease) in cash and cash equivalents	\$3,595	\$(4,869)
Cash and cash equivalents, beginning of period	\$5,152	\$8,599
Cash and cash equivalents, end of period	\$8,747	\$3,730

NON-CASH INVESTING AND FINANCING INFORMATION

Increase in asset retirement obligation assumed in acquisition	\$—	\$56
Senior common dividend issued in the dividend reinvestment program	\$—	\$53
Fixed asset additions paid for by tenant	\$2,570	\$—
Capital improvements included in accounts payable and accrued expenses	\$2,023	\$4,954

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

Table of Contents

Gladstone Commercial Corporation

Notes to Condensed Consolidated Financial Statements (Unaudited)

1. Organization, Basis of Presentation and Significant Accounting Policies

Gladstone Commercial Corporation is a real estate investment trust, or REIT, that was incorporated under the General Corporation Law of the State of Maryland on February 14, 2003. We focus on acquiring, owning and managing primarily office and industrial properties. On a selective basis, we may make long term industrial and commercial mortgage loans; however, we do not have any mortgage loans currently outstanding. 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. Gladstone Commercial Corporation conducts substantially all of its operations through a subsidiary, Gladstone Commercial Limited Partnership, a Delaware limited partnership, or the Operating Partnership.

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 U.S. generally accepted accounting principles, or GAAP, for interim financial information and pursuant to the requirements for reporting on Form 10-Q and in accordance with Article 10 of Regulation S-X. Accordingly, certain disclosures accompanying annual financial statements prepared in accordance with GAAP are omitted. The year-end balance sheet data presented herein was derived from audited financial statements, but does not include all disclosures required by GAAP. In the opinion of our management, all adjustments, consisting solely of normal recurring accruals, necessary for the fair presentation of financial statements for the interim period, have been included. The interim financial statements and notes thereto should be read in conjunction with the financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2015, as filed with the U.S. Securities and Exchange Commission on February 17, 2016. The results of operations for the three and nine months ended September 30, 2016 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.

Critical Accounting Policies

The preparation of our financial statements in accordance with GAAP requires management to make judgments that are subjective in nature in order to make certain estimates and assumptions. Application of these accounting policies involves the exercise of judgment regarding the use of assumptions as to future uncertainties, and as a result, actual results could materially differ from these estimates. A summary of all of our significant accounting policies is provided in Note 1 to our consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2015. There were no material changes to our critical accounting policies during the nine months ended September 30, 2016; however we issued mezzanine equity during the nine months ended September 30, 2016, which is further described in Note 10.

Table of Contents

Recently Issued Accounting Pronouncements

In February 2016, the FASB issued ASU 2016-02, “Leases: Amendments to the FASB Accounting Standards Codification” (“ASU 2016-02”), The new standard requires lessees to apply a dual approach, classifying leases as either finance or operating leases based on the principle of whether or not the lease is effectively a financed purchase by the lessee. This classification will determine whether lease expense is recognized based on an effective interest method or on a straight line basis over the term of the lease, respectively. A lessee is also required to record a right-of-use asset and a lease liability for all leases with a term of greater than 12 months regardless of their classification. Leases with a term of 12 months or less will be accounted for similar to existing guidance for operating leases today. The new standard requires lessors to account for leases using an approach that is substantially equivalent to existing guidance for sales-type leases, direct financing leases and operating leases. ASU 2016-02 is expected to minimally impact our consolidated financial statements as we currently have four operating ground lease arrangements for which we are the lessee. We also expect our legal expense to increase as the new standard requires us to expense indirect leasing costs that were previously capitalized to leasing commissions. ASC 2016-02 supersedes the previous leases standard, ASC 840 Leases. The standard is effective on January 1, 2019, with early adoption permitted.

In August 2016, the FASB issued ASU 2016-15, “Classification of Certain Cash Receipts and Cash Payments (a consensus of the Emerging Issues Task Force)” (“ASU 2016-15”), which is intended to reduce diversity in practice in how certain transactions are classified in the statement of cash flows. We are currently assessing the impact of ASU 2016-15 and do not anticipate a material impact on our financial position, results of operations or cash flows. ASU 2016-15 is effective for annual reporting periods beginning after December 15, 2017, including interim periods within those fiscal years, with early adoption permitted.

In October 2016, the FASB issued Accounting Standards Update 2016-17, “Interests Held through Related Parties That Are under Common Control” (“ASU 2016-17”), which amends the consolidation guidance in ASU 2015-02 regarding the treatment of indirect interests held through related parties that are under common control. We are currently assessing the impact of ASU 2016-17 and do not anticipate a material impact on our financial position, results of operations or cash flows. ASU 2016-17 is effective for annual reporting periods beginning after December 15, 2016 and interim periods within those years, with early adoption permitted.

Reclassifications

Certain prior year amounts have been reclassified to conform to the current year presentation.

In April 2015, the FASB issued ASU 2015-03, “Simplifying the Presentation of Debt Issuance Costs” (“ASU-2015-03”), which requires the presentation of debt issuance costs in the balance sheet as a deduction from the carrying amount of the related debt liability instead of a deferred financing cost. ASU 2015-03 was effective for annual periods beginning after December 15, 2015. We have adopted the provisions of ASU 2015-03 for the nine months ended September 30, 2016. We had unamortized deferred financing fees of \$5.6 million and \$6.1 million as of September 30, 2016 and December 31, 2015, respectively. These costs have been reclassified from deferred financing costs, net, to mortgage notes payable, net, borrowings under line of credit, net, borrowings under term loan facility, net, and Series C mandatorily redeemable preferred stock, net. All periods presented have been retrospectively adjusted.

The following table summarizes the retrospective adjustment and the overall impact on the previously reported consolidated financial statements (dollars in thousands):

	December 31, 2015	
	As Previously Reported	Retrospective Application
Deferred financing costs, net	\$ 6,138	\$ —
Mortgage notes payable, net	460,770	455,863
Borrowings under line of credit, net	45,300	44,591
Borrowings under term loan facility, net	25,000	24,878
Series C mandatorily redeemable preferred stock, net	38,500	38,100

Table of Contents

2. Related-Party Transactions

Gladstone Management and Gladstone Administration

We are externally managed pursuant to contractual arrangements with our Adviser and our Administrator, which collectively employ all of our personnel and pay their salaries, benefits, and general expenses directly. Both our Adviser and Administrator are affiliates of ours, as their parent company is owned and controlled by Mr. David Gladstone, our chairman and chief executive officer. Two of our executive officers, Mr. Gladstone and Mr. Terry Brubaker (our vice chairman and chief operating officer) serve as directors and executive officers of our Adviser and our Administrator. Mr. Michael LiCalsi, our general counsel and secretary, serves as our Administrator's president. We have an advisory agreement with our Adviser, and an administration agreement with our Administrator, or the Administration Agreement. The services and fees under the advisory agreement and Administration Agreement are described below. At September 30, 2016 and December 31, 2015, \$2.0 million and \$1.9 million, respectively, was collectively due to our Adviser and Administrator.

Base Management Fee

On July 24, 2015, we entered into a second amended and restated advisory agreement, with the Adviser effective July 1, 2015. We subsequently entered into a third amended and restated advisory agreement with the Adviser on July 12, 2016 effective July 1, 2016, or the Advisory Agreement. Our entrance into each of the amended agreements was approved unanimously by our Board of Directors. Our Board of Directors reviews and considers approving or renewing the agreement with our Adviser each July.

Effective July 1, 2015, the calculation of the annual base management fee equals 1.5% of our adjusted total stockholders' equity, which is our total stockholders' equity (before giving effect to the base management fee and incentive fee), adjusted to exclude the effect of any unrealized gains or losses that do not affect realized net income (including impairment charges) and adjusted for any one-time events and certain non-cash items (the later to occur for a given quarter only upon the approval of our Compensation Committee). The fee is calculated and accrued quarterly as 0.375% per quarter of such adjusted total stockholders' equity figure. Effective July 1, 2016, the definition of adjusted total stockholders' equity in the calculation of the base management fee and the incentive fee (described below) includes total mezzanine equity. All other provisions remained unchanged.

Prior to July 1, 2015, our then-existing advisory agreement with the Adviser, provided for an annual base management fee equal to 2.0% of our common stockholders' equity, which was our total stockholders' equity, less the recorded value of any preferred stock and adjusted to exclude the effect of any unrealized gains, losses, or other items that did not affect realized net income (including impairment charges).

For the three and nine months ended September 30, 2016, we recorded a base management fee of \$1.1 million and \$2.8 million, respectively, and for the three and nine months ended September 30, 2015, we recorded a base management fee of \$0.9 million and \$2.6 million, respectively.

Incentive Fee

Effective July 1, 2015, the calculation of the incentive fee was revised to reward the Adviser in circumstances where our quarterly Core FFO (defined at the end of this paragraph), before giving effect to any incentive fee, or pre-incentive fee Core FFO, exceeds 2.0% quarterly, or 8.0% annualized, of adjusted total stockholders' equity (after giving effect to the base management fee but before giving effect to the incentive fee), or the hurdle amount. Effective July 1, 2016, the definition of adjusted total stockholders' equity includes total mezzanine equity. The Adviser will receive 15.0% of the amount of our pre-incentive fee Core FFO that exceeds the hurdle amount. However, in no event shall the incentive fee for a particular quarter exceed by 15.0% (the cap) the average quarterly incentive fee paid by us for the previous four quarters (excluding quarters for which no incentive fee was paid). Core FFO (as defined in the Advisory Agreement) is GAAP net income (loss) available to common stockholders, excluding the incentive fee, depreciation and amortization, any realized and unrealized gains, losses or other non-cash items recorded in net income (loss) available to common stockholders for the period, and one-time events pursuant to changes in GAAP. Prior to July 1, 2015, our then-existing advisory agreement rewarded the Adviser in circumstances where our quarterly FFO, before giving effect to any incentive fee, or pre-incentive fee FFO, exceeded 1.75%, or 7.0% annualized, or the hurdle rate, of common stockholders' equity. Funds from operations, or FFO, included any realized capital gains and capital losses, less any distributions paid on preferred stock and Senior Common Stock, but FFO did

not include any unrealized capital gains or losses (including impairment charges). The Adviser received 100.0% of the amount of the pre-incentive fee FFO that exceeded the hurdle rate, but was less than 2.1875% of our common stockholders' equity. The Adviser also received an incentive fee of 20.0% of the amount of our pre-incentive fee FFO that exceeded 2.1875% of common stockholders' equity.

Table of Contents

For the three and nine months ended September 30, 2016, we recorded an incentive fee of \$0.6 million and \$1.8 million, respectively. For the three and nine months ended September 30, 2015, we recorded an incentive fee of \$0.6 million and \$4.1 million, respectively, offset by credits related to unconditional, voluntary and irrevocable waivers issued by the Adviser of \$0.0 million and \$2.5 million, respectively, resulting in a net incentive fee for the three and nine months ended September 30, 2015, of \$0.6 million and \$1.6 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 nine months covering January 1, 2015 through September 31, 2015 to support the current level of distributions to our stockholders. The Adviser did not waive any portion of the incentive fee for the three and nine months ended September 30, 2016. Waivers cannot be recouped by the Adviser in the future.

Capital Gain Fee

Under the Advisory Agreement, we will pay to the Adviser a capital gains-based incentive fee that will be calculated and payable in arrears as of the end of each fiscal year (or upon termination of the agreement). In determining the capital gain fee, we will calculate aggregate realized capital gains and aggregate realized capital losses for the applicable time period. For this purpose, aggregate realized capital gains and losses, if any, equals the realized gain or loss calculated by the difference between the sales price of the property, less any costs to sell the property and the current gross value of the property (which is calculated as the original acquisition price plus any subsequent non-reimbursed capital improvements). At the end of the fiscal year, if this number is positive, then the capital gain fee payable for such time period shall equal 15.0% of such amount. No capital gain fee was recognized during the three and nine months ended September 30, 2016 or 2015.

Termination Fee

The Advisory Agreement includes a termination fee whereby, in the event of our termination of the agreement without cause (with 120 days' prior written notice and the vote of at least two-thirds of our independent directors), a termination fee would be payable to the Adviser equal to two times the sum of the average annual base management fee and incentive fee earned by the Adviser during the 24-month period prior to such termination. A termination fee is also payable if the Adviser terminates the agreement after the Company has defaulted and applicable cure periods have expired. The agreement may also be terminated for cause by us (with 30 days' prior written notice and the vote of at least two-thirds of our independent directors), with no termination fee payable. Cause is defined in the agreement to include if the Adviser breaches any material provisions of the agreement, the bankruptcy or insolvency of the Adviser, dissolution of the Adviser and fraud or misappropriation of funds.

Administration Agreement

Pursuant to the Administration Agreement, we pay for our allocable portion of the Administrator's expenses in performing services to us, including, but not limited to, rent and the salaries and benefits of its personnel, including our chief financial officer, treasurer, chief compliance officer, general counsel and secretary (who also serves as our Administrator's president), and their respective staffs. Our allocable portion of the Administrator's expenses is derived by multiplying our Administrator's total expenses by the approximate percentage of time the Administrator's employees perform services for us in relation to their time spent performing services for all companies serviced by our Administrator under contractual agreements. For the three and nine months ended September 30, 2016, we recorded an administration fee of \$0.3 million and \$1.1 million, respectively, and for the three and nine months ended September 30, 2015, we recorded an administration fee of \$0.3 million and \$1.1 million, respectively. Our Board of Directors reviews and considers approving or renewing the agreement with our Administrator each July.

Gladstone Securities

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

Table of Contents

Dealer Manager Agreement

In connection with the offering of our Senior Common Stock (see Note 10, “Stockholders’ and Mezzanine Equity,” for further details) we entered into a Dealer Manager Agreement, dated March 25, 2011, or the Dealer Manager Agreement, with Gladstone Securities pursuant to which Gladstone Securities agreed to act as our exclusive dealer manager in connection with the offering. The Dealer Manager Agreement terminated according to its terms on March 28, 2015, requiring us to write-off \$0.1 million of deferred offering costs to general and administrative expense. Pursuant to the terms of the Dealer Manager Agreement, Gladstone Securities was entitled to receive a sales commission in the amount of 7.0% of the gross proceeds of the shares of Senior Common Stock sold, plus a dealer manager fee in the amount of 3.0% of the gross proceeds of the shares of Senior Common Stock sold. In addition, we agreed to indemnify Gladstone Securities against various liabilities, including certain liabilities arising under the federal securities laws. We made approximately \$0.3 million of payments during the nine months ended September 30, 2015, to Gladstone Securities pursuant to this agreement.

Mortgage Financing Arrangement Agreement

We entered into an agreement with Gladstone Securities, effective June 18, 2013, for it to act as our non-exclusive agent to assist us with arranging mortgage financing for properties we own. In connection with this engagement, Gladstone Securities may from time to time solicit the interest of various commercial real estate lenders or recommend to us third party lenders offering credit products or packages that are responsive to our needs. We pay Gladstone Securities a financing fee in connection with the services it provides to us for securing mortgage financing on any of our properties. The amount of these financing fees, which are payable upon closing of the financing, are based on a percentage of the amount of the mortgage, generally ranging from 0.15% to a maximum of 1.0% of the mortgage obtained. The amount of the financing fees may be reduced or eliminated, as determined by us and Gladstone Securities, after taking into consideration various factors, including, but not limited to, the involvement of any third party brokers and market conditions. We paid financing fees to Gladstone Securities of \$0.05 million and \$0.2 million during the three and nine months ended September 30, 2016, respectively, which are included in mortgage notes payable, net, in the condensed consolidated balance sheets, or 0.28% and 0.36% of total mortgages secured. We paid financing fees to Gladstone Securities of \$0.02 million and \$0.2 million during the three and nine months ended September 30, 2015, respectively, which are included in mortgage notes payable, net, in the condensed consolidated balance sheets, or 0.3% of total mortgages secured in each period. Our Board of Directors renewed the agreement for an additional year, through August 31, 2017, at its July 2016 meeting.

Table of Contents

3. Loss per Share of Common Stock

The following tables set forth the computation of basic and diluted loss per share of common stock for the three and nine months ended September 30, 2016 and 2015, respectively. We computed basic loss per share for the three and nine months ended September 30, 2016 and 2015, respectively, using the weighted average number of shares outstanding during the periods. Diluted loss per share for the three and nine months ended September 30, 2016 and 2015, reflects additional shares of common stock related to our convertible senior common stock (if the effect would be dilutive), that would have been outstanding if dilutive potential shares of common stock had been issued, as well as an adjustment to net income available to common stockholders as applicable to common stockholders that would result from their assumed issuance (dollars in thousands, except per share amounts).

	For the three months ended September 30, 2016		For the nine months ended September 30, 2015	
Calculation of basic loss per share of common stock:				
Net loss attributable to common stockholders	\$(2,329)	\$(1,382)	\$(3,385)	\$(2,788)
Denominator for basic weighted average shares of common stock	23,509,054	21,403,808	22,915,080	20,820,559
Basic loss per share of common stock	\$(0.10)	\$(0.06)	\$(0.15)	\$(0.13)
Calculation of diluted loss per share of common stock:				
Net loss attributable to common stockholders	\$(2,329)	\$(1,382)	\$(3,385)	\$(2,788)
Net loss attributable to common stockholders plus assumed conversions (1)	\$(2,329)	\$(1,382)	\$(3,385)	\$(2,788)
Denominator for basic weighted average shares of common stock	23,509,054	21,403,808	22,915,080	20,820,559
Effect of convertible senior common stock (1)	—	—	—	—
Denominator for diluted weighted average shares of common stock (1)	23,509,054	21,403,808	22,915,080	20,820,559
Diluted loss per share of common stock	\$(0.10)	\$(0.06)	\$(0.15)	\$(0.13)

We excluded 800,116 shares of convertible senior common stock from the calculation of diluted earnings per share for the three and nine months ended September 30, 2016, respectively, because it was anti-dilutive. We also (1) excluded 828,444 shares and 791,582 shares of convertible senior common stock from the calculation of diluted earnings per share for the three and nine months ended September 30, 2015, respectively, 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, 2016 and December 31, 2015, excluding real estate held for sale as of September 30, 2016 and December 31, 2015, respectively (dollars in thousands):

	September 30, 2016	December 31, 2015
Real estate:		
Land	\$102,101	\$97,117
Building	644,662	635,728
Tenant improvements	50,352	47,532
Accumulated depreciation	(125,250)	(112,243)
Real estate, net	\$671,865	\$668,134

Real estate depreciation expense on building and tenant improvements was \$6.1 million and \$17.9 million for the three and nine months ended September 30, 2016, respectively, and \$5.7 million and \$16.4 million for the three and nine months ended September 30, 2015, respectively.

During the nine months ended September 30, 2016, we acquired two properties, which are summarized below (dollars in thousands):

Location	Acquisition Date	Square Footage (unaudited)	Lease Term	Renewal Options	Total Purchase Price	Acquisition Expenses	Annualized GAAP Rent	Debt Issued
Salt Lake City, UT	5/26/2016	107,062	6 Years	2 (3 Years and 2 Years)	\$ 17,000	\$ 105	\$ 1,393	\$9,900
Fort Lauderdale, FL	9/12/2016	119,224	9 Years	2 (5 Years)	23,900	74	1,974	14,100
Total		226,286			\$40,900	\$ 179	\$ 3,367	\$24,000

In accordance with Accounting Standards Codification, or ASC, 805, "Business Combinations," we determined the fair value of the acquired assets related to the two properties acquired during the nine months ended September 30, 2016 as follows (in thousands):

Location	Land	Building	Tenant Improvements	In-place Leases	Leasing Costs	Customer Relationships	Below Market Leases	Total Purchase Price
Salt Lake City, UT	\$3,008	\$8,973	\$ 1,685	\$ 1,352	\$337	\$ 1,675	\$(30)	\$ 17,000
Fort Lauderdale, FL	4,117	13,961	1,555	2,003	1,100	1,415	(251)	23,900
	\$7,125	\$22,934	\$ 3,240	\$3,355	\$ 1,437	\$ 3,090	\$(281)	\$ 40,900

Below is a summary of the total revenue and earnings recognized on the two properties acquired during the nine months ended September 30, 2016 (dollars in thousands):

		For the three months ended September 30, 2016	For the nine months ended September 30, 2016
Location	Acquisition Date	Rental Revenue	Rental Revenue
Salt Lake City, UT	5/26/2016	\$358 \$ (22)	\$497 \$ (143) (1)
Fort Lauderdale, FL	9/12/2016	106 (60) (2)	106 (60) (2)
		\$464 \$ (82)	\$603 \$ (203)

(1) Includes \$0.1 million of non-recurring acquisition costs.

(2) Includes \$0.07 million of non-recurring acquisition costs.

Table of Contents

Pro Forma

The following table reflects pro-forma consolidated statements of operations as if the properties acquired during the nine months ended September 30, 2016, were acquired as of January 1, 2015, and the properties acquired during 2015, were acquired as of January 1, 2014. The pro-forma earnings for the nine months ended September 30, 2016 and 2015 were adjusted to assume that the acquisition-related costs were incurred as of the assumed acquisition date (dollars in thousands, except per share amounts):

	For the three months ended September 30, (unaudited) 2016		For the nine months ended September 30, (unaudited) 2016	
	2016	2015	2016	2015
Operating Data:				
Total operating revenue	\$22,012	\$ 22,463	\$66,406	\$ 67,222
Total operating expenses	(15,205)	(13,785)	(42,968)	(41,204)
Other expenses	(6,612)	(8,159)	(21,453)	(24,499)
Net income	195	519	1,985	1,519
Dividends attributable to preferred and senior common stock	(2,256)	(1,286)	(5,050)	(3,818)
Net loss attributable to common stockholders	\$(2,061)	\$(767)	\$(3,065)	\$(2,299)
Share and Per Share Data:				
Basic and diluted loss per share of common stock - pro forma	\$(0.09)	\$(0.04)	\$(0.13)	\$(0.11)
Basic and diluted loss per share of common stock - actual	\$(0.10)	\$(0.06)	\$(0.15)	\$(0.13)
Weighted average shares outstanding-basic and diluted	23,509,054	21,403,808	22,915,082	20,820,559

Significant Real Estate Activity on Existing Assets

During the nine months ended September 30, 2016, we executed seven leases, which are summarized below (dollars in thousands):

Location	Lease Commencement Date	Square Footage (unaudited)	Lease Term	Renewal Options	Annualized GAAP Rent	Tenant Improvements	Leasing Commissions
Maple Heights, OH	6/1/2016	40,606	(1)5.2 Years	2 (3 year)	\$ 109	\$ —	\$ 34
Bolingbrook, IL	7/1/2016	13,816	(2)7.2 Years	1 (5 year)	70	69	28
Richmond, VA	N/A	42,213	(3)3 Years	N/A	228	—	—
Maple Heights, OH	N/A	180,000	(4)1 Year	N/A	530	60	—
Burnsville, MN	12/1/2016	12,663	(5)5.3 Years	1 (5 year)	143	—	104
South Hadley, MA	N/A	150,000	(6)1 Year	1 (1 year)	288	—	7
Bolingbrook, IL	1/2/2017	20,719	(7)7.3 Years	1 (5 year)	107	204	48

(1) Tenant's lease is for 11.7% of the building. The building is now 63.5% leased.

(2) Tenant's lease is for 24.9% of the building. The building is now 100.0% leased.

(3) Tenant extended their current lease for an additional 3 years, expiring December 2019.

(4) Tenant extended their current lease for an additional year, expiring December 2019. The tenant also exercised their contraction right and downsized their square footage. The building is now 63.5% leased.

(5) Tenant's lease is for 11.0% of the building. The building is now 80.4% leased.

(6) Tenant extended their current lease for an additional year, expiring February 2018.

(7) Tenant's lease is for 37.3% of the building. The building is now 100.0% leased.

On May 31, 2016, we reached a legal settlement with the previous tenant at our currently vacant Newburyport, Massachusetts property to compensate us for deferred capital obligations and repairs they were required to perform during their tenancy. We recognized \$0.3 million, recorded in other income on the condensed consolidated statement of operations, related to reimbursed deferred capital obligations, and received \$0.9 million as a reimbursement of repairs incurred during the three and nine months ended September 30, 2016 in connection with the legal settlement received, which was recorded net against operating expenses on the condensed consolidated statement of operations.

Table of Contents

2015 Real Estate Activity

Investment Activity

During the nine months ended September 30, 2015, we acquired five properties, which are summarized below (dollars in thousands):

Location	Acquisition Date	Square Footage (unaudited)	Lease Term	Renewal Options	Total Purchase Price	Acquisition Expenses	Annualized GAAP Rent	Debt Issued
Richardson, TX	(1) 3/6/2015	155,984	9.5 Years	2 (5 years each)	\$ 24,700	\$ 112	\$ 2,708	\$14,573
Birmingham, AL	3/20/2015	30,850	8.5 Years	1 (5 years)	3,648	76	333	N/A
Columbus, OH	5/28/2015	78,033	15.0 Years	2 (5 years each)	7,700	72	637	4,466
Salt Lake City, UT	(1) 5/29/2015	86,409	6.5 Years	1 (5 years)	22,200	149	2,411	13,000
Atlanta, GA	(2) 7/15/2015	78,151	Multiple	(2) 2 (5 years)	13,000	109	1,291	7,540
Total		429,427			\$ 71,248	\$ 518	\$ 7,380	\$39,579

(1) The tenant occupying this property is subject to a gross lease.

(2) This building is 100% leased to one tenant through two leases. The lease for 30% of the space expires in July 2030 and the lease for the remaining space expires in July 2022.

In accordance with ASC 805, we determined the fair value of the acquired assets and assumed liabilities related to the five properties acquired during the nine months ended September 30, 2015, as follows (in thousands):

Location	Land	Building	Tenant Improvements	In-place Leases	Leasing Costs	Customer Relationships	Above Market Leases	Below Market Leases	Total Purchase Price
Richardson, TX	\$2,728	\$12,591	\$ 2,781	\$ 2,060	\$ 1,804	\$ 1,929	\$ 807	\$—	\$ 24,700
Birmingham, AL	650	1,683	351	458	146	360	—	—	3,648
Columbus, OH	1,338	3,511	1,547	1,144	672	567	—	(1,079)	7,700
Salt Lake City, UT	3,248	11,861	1,268	2,396	981	1,678	821	(53)	22,200
Atlanta, GA	2,271	7,862	916	750	548	723	44	(114)	13,000
	\$10,235	\$37,508	\$ 6,863	\$ 6,808	\$4,151	\$ 5,257	\$ 1,672	\$(1,246)	\$ 71,248

Below is a summary of the total revenue and earnings recognized on the five properties acquired during the three and nine months ended September 30, 2015 (dollars in thousands):

Location	Acquisition Date	For the three months ended September 30, 2015	For the nine months ended September 30, 2015
		Rental Revenue (1)	Rental Revenue (1)
Richardson, TX	3/6/2015	\$656	\$1,496
Birmingham, AL	3/20/2015	83	177
		Earnings (1)	Earnings (1)
		\$ (57)	\$ (22)
		(28)	6

Edgar Filing: GLADSTONE COMMERCIAL CORP - Form 10-Q

Columbus, OH	5/28/2015	177	(28	)	244	32	(3)
Salt Lake City, UT	5/29/2015	572	14		780	122	(4)
Atlanta, GA	7/15/2015	274	28	(5)	274	28	(5)
		\$1,762	\$ (71	)	\$2,971	\$ 166	

(1)Includes \$0.1 million of non-recurring acquisition costs.

(2)Includes \$0.08 million of non-recurring acquisition costs.

(3)Includes \$0.07 million of non-recurring acquisition costs.

(4)Includes \$0.1 million of non-recurring acquisition costs.

(5)Includes \$0.1 million of non-recurring acquisition costs.

Table of Contents

Leasing Activity

During the nine months ended September 30, 2015, we amended nine of our leases, which are summarized below (dollars in thousands):

Location	New Lease Effective Date	Square Footage (unaudited)	New Lease Term	Renewal Options	Annualized GAAP Rent	Tenant Improvements	Leasing Commissions
Indianapolis, IN	1/1/2015	3,546	8.3 Years	N/A	\$ 64	\$ 64	\$ 28
Indianapolis, IN	2/1/2015	8,275	3.0 Years	N/A	124	—	—
Raleigh, NC	2/1/2015	58,926	5.5 Years	2 (5 year)	711	—	144
Raleigh, NC	2/1/2015	21,300	5.5 Years	2 (5 year)	239	100	32
Columbus, OH	12/1/2016	9,484	(1) 7.1 Years	N/A	1,246	142	29
Raleigh, NC	8/1/2015	86,886	(2) 12.4 Years	2 (5 year)	534	800	398
Indianapolis, IN	8/1/2015	6,903	3 Years	N/A	111	64	16
Baytown, TX	9/18/2015	6,791	(3) 7 Years	2 (5 year)	132	360	71
Indianapolis, IN	10/1/2015	1,427	(4) 3 Years	N/A	22	—	4
		203,538			3,183	1,530	722

- (1) The anchor tenant currently occupying 92.0% of the building will expand into the remaining space, currently occupied by another tenant through November 30, 2016.
- (2) Tenant's lease is for 74.8% of the building. The building is now 93.2% leased.
- (3) Tenant's lease is for 56.6% of the building. The building is now 56.6% leased.
- (4) Tenant's lease is for 1.6% of the building. The building is now 95.9% leased.

Intangible Assets

The following table summarizes the carrying value of intangible assets, liabilities and the accumulated amortization for each intangible asset and liability class as of September 30, 2016 and December 31, 2015, excluding real estate held for sale as of September 30, 2016 and December 31, 2015, respectively (in thousands):

	September 30, 2016			December 31, 2015		
	Lease Intangibles	Accumulated Amortization		Lease Intangibles	Accumulated Amortization	
In-place leases	\$68,681	\$ (26,469	)	\$66,244	\$ (22,679)
Leasing costs	45,555	(17,320	)	44,360	(14,774)
Customer relationships	48,774	(16,456	)	46,485	(14,722)
	\$163,010	\$ (60,245	)	\$157,089	\$ (52,175)
	Deferred Rent Receivable	Accumulated (Amortization)/Accretion (Liability)		Deferred Rent Receivable	Accumulated (Amortization)/Accretion (Liability)	
Above market leases	\$10,292	\$ (7,175	)	\$10,176	\$ (6,818)
Below market leases and deferred revenue	(19,813	) 8,538		(17,951	) 8,294	
	\$ (9,521	) \$ 1,363		\$ (7,775	) \$ 1,476	

Total amortization expense related to in-place leases, leasing costs and customer relationship lease intangible assets was \$3.4 million and \$9.9 million for the three and nine months ended September 30, 2016, respectively, and \$3.3 million and \$9.7 million for the three and nine months ended September 30, 2015, respectively, and is included in depreciation and amortization expense in the condensed consolidated statement of operations.

Table of Contents

Total amortization related to above-market lease values was \$0.1 million and \$0.4 million for the three and nine months ended September 30, 2016, respectively, and \$0.1 million and \$0.3 million for the three and nine months ended September 30, 2015, respectively, and is included in rental revenue in the condensed consolidated statement of operations. Total amortization related to below-market lease values was \$0.3 million and \$0.7 million for the three and nine months ended September 30, 2016, respectively, and \$0.2 million and \$0.7 million for the three and nine months ended September 30, 2015, respectively, and is included in rental revenue in the condensed consolidated statement of operations.

The weighted average amortization periods in years for the intangible assets acquired and liabilities assumed during the nine months ended September 30, 2016 and 2015, respectively, were as follows:

Intangible Assets & Liabilities	2016	2015
In-place leases	7.9	11.5
Leasing costs	7.9	11.5
Customer relationships	12.2	16.1
Above market leases	—	17.2
Below market leases	7.9	13.5
All intangible assets & liabilities	9.0	12.9

5. Real Estate Dispositions, Held for Sale, and Impairment Charges

Real Estate Dispositions

On May 16, 2016, we completed the sale of our Dayton, Ohio property for \$0.2 million. There was no gain or loss recognized on this sale. We considered this office asset to be non-core to our long term strategy, and we re-deployed the proceeds to pay down outstanding debt.

On August 24, 2016, we completed the sale of our property located in Rock Falls, Illinois, and our two properties located in Angola, Indiana for an aggregate of \$3.0 million and recognized a loss of \$0.02 million. We considered these industrial assets to be non-core to our long term strategy, and we re-deployed the proceeds to pay down outstanding debt.

Per ASU 2014-08, "Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity," our 2016 dispositions were not classified as discontinued operations because they do not represent a strategic shift in operations, nor will they have a major effect on our operations and financial results.

The table below summarizes the components of operating income from the real estate and related assets disposed of during the three and nine months ended September 30, 2016, and 2015, respectively (dollars in thousands):

	For the three months ended September 30,		For the nine months ended September 30,	
	2016	2015	2016	2015
Operating revenue	\$50	\$132	\$271	\$538
Operating expense	4	702	(1)193	(2)872
Other expense	(10)	(41)	(69)	(155)
Income (loss) from real estate and related assets sold	\$36	\$(611)	\$9	\$(489)

(1) Includes a \$0.6 million impairment charge on our Dayton, Ohio property.

(2) Includes a \$0.04 million impairment charge on our Dayton, Ohio property and a \$0.02 million impairment charge on our Angola, IN and Rock Falls, IL properties.

Table of Contents

Real Estate Held for Sale

As of September 30, 2016, we classified five properties (located in Montgomery, Alabama, Hazelwood, Missouri, Syracuse, New York, Toledo, Ohio and South Hadley, Massachusetts) as held for sale under the provisions of ASC 360-10, "Property, Plant, and Equipment." ASC 360-10 requires that the assets and liabilities of any such properties, be presented separately in our condensed consolidated balance sheet in the current period presented, and that we cease recording depreciation and amortization expense. We consider all five of these assets to be non-core to our long term strategy. We have executed sales agreements for the Montgomery, Alabama, Hazelwood, Missouri, and Toledo, Ohio properties, and are actively looking for buyers for the Syracuse, New York and South Hadley, Massachusetts properties. We anticipate the Hazelwood, Missouri property sale will close during second quarter 2017, and we currently anticipate the remaining four properties to sell during the fourth quarter 2016.

Per ASU 2014-08, our assets classified as held for sale were not classified as discontinued operations because they do not represent a strategic shift in our operations, nor will they have a major effect on our operations and financial results.

The table below summarizes the components of income from real estate and related assets held for sale (dollars in thousands):

	For the three months ended September 30,		For the nine months ended September 30,	
	2016	2015	2016	2015
Operating revenue	\$362	\$357	\$1,090	\$1,074
Operating expense	1,918	(1) 151	2,426	(2) 484
Other expense	(108)	(138)	(338)	(412)
(Loss) income from real estate and related assets held for sale	\$(1,664)	\$68	\$(1,674)	\$178

(1) Includes \$1.8 million impairment charge on our five properties held for sale.

(2) Includes \$2.0 million impairment charge on our five properties held for sale.

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

	September 30, 2016	December 31, 2015
ASSETS HELD FOR SALE		
Real estate, at cost	\$ 15,051	\$ 1,899
Less: accumulated depreciation	3,904	846
Total real estate held for sale, net	11,147	1,053
Lease intangibles, net	299	—
Deferred rent receivable, net	297	—
Other assets	5	24
TOTAL ASSETS HELD FOR SALE	\$ 11,748	\$ 1,077
LIABILITIES HELD FOR SALE		
Deferred rent liability, net	\$ 239	\$ —
Asset retirement obligation	449	75
Accounts payable and accrued expenses	—	1
Other liabilities	—	792
TOTAL LIABILITIES HELD FOR SALE	\$ 688	\$ 868

Table of Contents

Impairment Charges

We performed an evaluation and analysis on our held for sale properties and recorded impairment charges of \$1.8 million and \$2.0 million for the three and nine months ended September 30, 2016, and \$0.6 million for both the three and nine months ended September 30, 2015, respectively. We recognized impairment charges of \$0.04 million on our Dayton, Ohio property and \$0.02 million on our Angola, Indiana and Rock Falls, Illinois properties, which were sold during the nine months ended September 30, 2016. We also recognized \$0.2 million, \$0.7 million and \$1.1 million of impairment charges on our Montgomery, Alabama, Hazelwood, Missouri and South Hadley, Massachusetts properties, respectively, which are all classified as held for sale in the accompanying condensed consolidated balance sheet, during the nine months ended September 30, 2016. We recognized impairment on these assets as the hold period for these assets was shortened when they met the definition of held for sale.

We recognized \$0.6 million of impairment charges on our Dayton, Ohio property during the nine months ended September 30, 2015. This property was sold in May 2016.

The fair values for the above properties were calculated using Level 3 inputs which were calculated using an estimated sales price, less estimated costs to sell. The estimated sales price was determined using an executed purchase and sale agreement, auction house price ranges and real estate broker guidance.

6. Mortgage Note Receivable

On July 25, 2014, we closed a \$5.6 million second mortgage development loan for the construction of an 81,371 square foot, build-to-suit transitional care facility located on a major hospital campus in Phoenix, Arizona.

Subsequently, on April 14, 2015, we closed an additional \$0.3 million interim financing loan for the development of the Phoenix, Arizona property. Construction was completed in July 2015 and we earned 9.0% interest, paid currently in cash, on the loan during construction and through maturity. Prior to completion of the facility, we were granted a right of first offer to purchase the property at fair value. We elected not to purchase the property, and received an exit fee upon maturity of the loan in an amount sufficient for us to earn an internal rate of return of 22.0% on the second mortgage development loan, inclusive of interest earned. We recognized \$0.4 million in both cash interest income and exit fee revenue during the nine months ended September 30, 2016. We recognized \$0.3 million and \$0.8 million, respectively, in both cash interest income and exit fee revenue during the three and nine months ended September 30, 2015, respectively. The principal balance of the loans and all associated interest and exit fee revenue was received in January 2016. We currently have no mortgage notes receivable outstanding.

Table of Contents

7. Mortgage Notes Payable, Line of Credit and Term Loan Facility

Our mortgage notes payable and line of credit as of September 30, 2016 and December 31, 2015 are summarized below (dollars in thousands):

	Encumbered properties at September 30, 2016	Carrying Value at		Stated Interest Rates at September 30, 2016	Scheduled Maturity Dates at (4) September 30, 2016
		September 30, 2016	December 31, 2015		
Mortgage and Other Secured Loans:					
Fixed rate mortgage loans	54	\$385,102	\$427,334	(1)	(2)
Variable rate mortgage loans	17	64,161	33,044	(3)	(2)
Premiums and discounts, net	-	247	392	N/A	N/A
Deferred financing costs, mortgage loans, net	-	(4,988)	(4,907)	N/A	N/A
Total Mortgage Notes Payable, net	71	\$444,522	\$455,863	(5)	
Variable rate Line of Credit	25	(6) 47,300	45,300	LIBOR + 2.50%	8/7/2018
Deferred financing costs, line of credit	-	(528)	(709)	N/A	N/A
Total Line of Credit, net	25	\$46,772	\$44,591		
Variable rate Term Loan Facility	-	25,000	25,000	LIBOR + 2.45%	10/5/2020
Deferred financing costs, term loan facility	-	(108)	(122)	N/A	N/A
Total Term Loan Facility, net	N/A	\$24,892	\$24,878		
Total Mortgage Notes Payable, Line of Credit and Term Loan Facility	96	\$516,186	\$525,332		

(1) Interest rates on our fixed rate mortgage notes payable vary from 3.75% to 6.63%.

(2) We have 43 mortgage notes payable with maturity dates ranging from 12/1/2016 through 7/1/2045.

(3) Interest rates on our variable rate mortgage notes payable vary from one month LIBOR + 2.15% to one month LIBOR + 2.75%. At September 30, 2016, one month LIBOR was approximately 0.53%.

(4) The weighted average interest rate on all debt outstanding at September 30, 2016 was approximately 4.47%.

(5) The weighted average interest rate on the mortgage notes outstanding at September 30, 2016 was approximately 4.71%.

(6) The amount we may draw under our line of credit and term loan facility is based on a percentage of the fair value of a combined pool of 25 unencumbered properties as of September 30, 2016.

N/A - Not Applicable

Table of Contents

Mortgage Notes Payable

As of September 30, 2016, we had 43 mortgage notes payable, collateralized by a total of 71 properties with a net book value of \$638.5 million. Gladstone Commercial Corporation has limited recourse liabilities that could result from any one or more of the following circumstances: a borrower voluntarily filing for bankruptcy, improper conveyance of a property, fraud or material misrepresentation, misapplication or misappropriation of rents, security deposits, insurance proceeds or condemnation proceeds, or physical waste or damage to the property resulting from a borrower's gross negligence or willful misconduct. Gladstone Commercial Corporation has full recourse for \$7.4 million of the mortgages notes payable outstanding, or 1.7% of the outstanding balance. We will also indemnify lenders against claims resulting from the presence of hazardous substances or activity involving hazardous substances in violation of environmental laws on a property.

During the nine months ended September 30, 2016, we repaid 6 mortgages, collateralized by 12 properties, and issued 5 long-term mortgages, collateralized by 10 properties, which are summarized below (dollars in thousands):

Date of Issuance/Repayment	Issuing Bank	New Debt Issued	Interest Rate	Maturity Date	Principal Balance Repaid	Previous Interest Rate
3/1/2016	Key Bank	\$18,475	LIBOR + 2.35%	(1) 3/1/2023	\$21,197	6.14%
4/22/2016	Great Southern Bank	9,530	LIBOR + 2.75%	(2) 4/22/2019	3,667	6.25%
4/28/2016	N/A	N/A	N/A	(3) N/A	22,510	6.34%
5/26/2016	Prudential	9,900	4.684%	(4) 6/1/2026	N/A	N/A
9/1/2016	N/A	N/A	N/A	(5) N/A	12,677	5.76%
9/12/2016	Union Fidelity Life Insurance Company	14,100	4.25%	(6) 10/5/2026	N/A	N/A
9/30/2016	Huntington Bank	4,000	LIBOR + 2.50%	(7) 9/30/2018	N/A	N/A

We refinanced maturing debt on our Chalfont, Pennsylvania, Big Flats, New York and Franklin and Eatontown, (1) New Jersey properties, which was originally set to mature during second quarter 2016. We entered into an interest rate cap agreement with Key Bank, which caps LIBOR at 3% through March 1, 2019.

We refinanced maturing debt on our Coppell, Texas property, which was originally set to mature during second (2) quarter 2016. We pooled the new mortgage debt with unencumbered properties located in Allen and Colleyville, Texas. We entered into an interest rate cap agreement with Great Southern Bank, which caps LIBOR at 2.5% through April 22, 2019.

We repaid our \$10.7 million mortgage on our Springfield, Missouri property that was originally set to mature on (3) July 1, 2016, and we repaid our \$11.8 million mortgage on our Wichita, Kansas, Clintonville, Wisconsin, Angola, Indiana and Rock Falls, Illinois properties that was originally set to mature on May 5, 2016. We repaid both mortgages using existing cash on hand and borrowings from our line of credit.

(4) We borrowed \$9.9 million to acquire the property in Salt Lake City, Utah.

We repaid our \$12.7 million mortgage on our Lexington, North Carolina, Arlington, Texas and San Antonio, Texas (5) properties that was originally set to mature on December 1, 2016. We repaid this mortgage using existing cash on hand and borrowings from our line of credit.

(6) We borrowed \$14.1 million to acquire the property in Fort Lauderdale, Florida.

We obtained financing for our Maple Heights, Ohio property, which was previously in the unencumbered pool of (7) assets on our line of credit. We entered into an interest rate cap agreement with Huntington Bank, which caps LIBOR at 2.5% through September 30, 2019.

We made payments of \$0.4 million and \$1.0 million for deferred financing costs during the three and nine months ended September 30, 2016, respectively, and payments of \$0.3 million and \$1.2 million during the three and nine

months ended September 30, 2015, respectively.

Table of Contents

Scheduled principal payments of mortgage notes payable for the remainder of 2016, and each of the five succeeding fiscal years and thereafter are as follows (dollars in thousands):

Year	Scheduled Principal Payments
Three Months Ending December 31, 2016	\$ 10,213
2017	70,441
2018	46,367
2019	45,818
2020	12,280
2021	24,507
Thereafter	239,637
Total	\$ 449,263 (1)

(1) This figure does not include \$0.2 million of premiums and (discounts), net and \$5.0 million of deferred financing costs, which are reflected in mortgage notes payable on the condensed consolidated balance sheet.

Interest Rate Cap Agreements

We have entered into interest rate cap agreements that cap the interest rate on certain of our variable-rate notes payable. We have adopted the fair value measurement provisions for our financial instruments recorded at fair value. The fair value guidance establishes a three-tier value hierarchy, which prioritizes the inputs used in measuring fair value. These tiers include: Level 1, defined as observable inputs such as quoted prices in active markets; Level 2, defined as inputs other than quoted prices in active markets that are either directly or indirectly observable; and Level 3, defined as unobservable inputs in which little or no market data exists, therefore requiring an entity to develop its own assumptions. Generally, we will estimate the fair value of our interest rate caps, in the absence of observable market data, using estimates of value including estimated remaining life, counterparty credit risk, current market yield and interest rate spreads of similar securities as of the measurement date. At September 30, 2016 and December 31, 2015, our interest rate cap agreements were valued using Level 2 inputs.

The fair value of the interest rate cap agreements is recorded in other assets on our accompanying condensed consolidated balance sheets. We record changes in the fair value of the interest rate cap agreements quarterly based on the current market valuations at quarter end as interest expense on our accompanying condensed consolidated statements of operations. The following table summarizes the key terms of each interest rate cap agreement (dollars in thousands):

Interest Rate Cap	LIBOR Cap	Maturity Date	Cost	September 30, 2016		December 31, 2015	
				Notional Amount	Fair Value	Notional Amount	Fair Value
11/2013	3.00 %	12/2016	\$31	\$8,200	\$ —	\$8,200	\$ —
7/2015	3.00 %	7/2018	68	20,709	—	21,204	14
12/2015	3.00 %	12/2020	52	3,574	5	3,640	26
3/2016	3.00 %	03/2019	33	18,260	2	—	—
4/2016	2.50 %	04/2019	27	9,441	2	—	—
9/2016	2.50 %	9/2019	46	4,000	46	—	—
			\$257	\$64,184	\$ 55	\$33,044	\$ 40

The fair value of all mortgage notes payable outstanding as of September 30, 2016 was \$454.6 million, as compared to the carrying value stated above of \$449.3 million. The fair value is calculated based on a discounted cash flow analysis, using management's estimate of market interest rates on long-term debt with comparable terms and loan to value ratios. The fair value was calculated using Level 3 inputs of the hierarchy established by ASC 820, "Fair Value

Measurements and Disclosures.”

21

Table of Contents

Line of Credit and Term Loan Facility

In August 2013, we procured a senior unsecured revolving credit facility, or the Line of Credit, with KeyBank National Association (serving as a revolving lender, a letter of credit issuer and an administrative agent). On October 5, 2015, we expanded our Line of Credit to \$85.0 million, extended the maturity date one-year through August 2018, with a one year extension option through August 2019 and entered into a \$25.0 million Term Loan Facility (discussed below). The interest rate on the Line of Credit was also reduced by 25 basis points at each of the leverage tiers.

In connection with the Line of Credit expansion in October 2015 mentioned above, we added a \$25.0 million, five year term loan facility, or the Term Loan Facility, which was fully drawn at closing and matures in October 2020. The Term Loan Facility is subject to the same leverage tiers as the Line of Credit; however the interest rate at each leverage tier is five basis points lower. We have the option to repay the Term Loan Facility in full, or in part, at any time without penalty or premium prior to the maturity date.

The total maximum commitment under the two facilities, including the Line of Credit and Term Loan Facility is \$150.0 million. The bank syndicate is comprised of KeyBank, Comerica Bank, Fifth Third Bank, US Bank and Huntington Bank.

As of September 30, 2016, there was \$72.3 million outstanding under our Line of Credit and Term Loan Facility at a weighted average interest rate of approximately 3.01% and \$2.5 million outstanding under letters of credit at a weighted average interest rate of 2.5%. As of September 30, 2016, the maximum additional amount we could draw under the Line of Credit was \$27.4 million. We were in compliance with all covenants under the Line of Credit and Term Loan Facility as of September 30, 2016.

The amount outstanding under the Line of Credit and Term Loan Facility approximates fair value as of September 30, 2016, as the debt is variable rate.

8. Mandatorily Redeemable Term Preferred Stock

In February 2012, we completed a public offering of 1,540,000 shares of 7.125% Series C Cumulative Term Preferred Stock, par value \$0.001 per share, or the Term Preferred Stock, at a public offering price of \$25.00 per share. Gross proceeds of the offering totaled \$38.5 million and net proceeds, after deducting offering expenses borne by us, were \$36.7 million. The shares of the Term Preferred Stock had a mandatory redemption date of January 31, 2017.

During the nine months ended September 30, 2016, we redeemed all outstanding shares of the Term Preferred Stock. Accordingly, we wrote-off unamortized offering costs of \$0.06 million and \$0.2 million during the three and nine months ended September 30, 2016, respectively, which were recorded to interest expense in our condensed consolidated statements of operations.

The Term Preferred Stock was recorded as a liability in accordance with ASC 480, "Distinguishing Liabilities from Equity," which states that mandatorily redeemable financial instruments should be classified as liabilities and therefore the related dividend payments are treated as a component of interest expense in the condensed consolidated statements of operations.

9. Commitments and Contingencies

Ground Leases

We are obligated as lessee under four ground leases. Future minimum rental payments due under the terms of these leases as of September 30, 2016, are as follows (dollars in thousands):

Location	Lease End Date	For the three months ending December 31,	For the year ending December 31,				
		2016	2017	2018	2019	2020	Thereafter
Tulsa, OK	Apr-21	\$ 42	\$169	\$169	\$169	\$169	\$ 85

Edgar Filing: GLADSTONE COMMERCIAL CORP - Form 10-Q

Springfield, MA	Feb-30	21	89	90	90	90	884
Dartmouth, MA	May-36	44	174	174	174	174	3,126
Salt Lake City, UT	Nov-40	7	30	31	32	33	853
		\$ 114	\$462	\$464	\$465	\$466	\$ 4,948

22

Table of Contents

Expenses recorded in connection to rental expense incurred for the properties listed above during the three and nine months ended September 30, 2016 were \$0.1 million and \$0.4 million, respectively, and during the three and nine months ended September 30, 2015 were \$0.1 million and \$0.3 million, respectively. Rental expenses are reflected in property operating expenses on the condensed consolidated statements of operations.

Letters of Credit

As of September 30, 2016, there was \$2.5 million outstanding under letters of credit. These letters of credit are not reflected on our consolidated balance sheet.

10. Stockholders' and Mezzanine Equity

Stockholders' Equity

The following table summarizes the changes in our stockholders' equity for the nine months ended September 30, 2016 (dollars in thousands):

	Shares Issued and Retired								
	Preferred Stock Series A and B	Common Stock	Senior Common Stock	Preferred Stock Series A and B	Senior Common Stock	Common Stock	Additional Paid in Capital	Distributions in Excess of Accumulated Earnings	Total Stockholders' Equity
Balance at December 31, 2015	2,150,000	22,485,607	972,214	\$ 2	\$ 1	\$ 22	\$418,897	\$(185,051)	\$ 233,871
Issuance of preferred stock series A and B and common stock, net	114,000	1,115,546	—	—	—	2	21,417	—	21,419
Retirement of senior common stock	—	—	(12,662)	—	—	—	(178)	—	(178)
Distributions declared to common, senior common and preferred stockholders	—	—	—	—	—	—	—	(30,862)	(30,862)
Net income	—	—	—	—	—	—	—	1,665	1,665
Balance at September 30, 2016	2,264,000	23,601,153	959,552	\$ 2	\$ 1	\$ 24	\$440,136	\$(214,248)	\$ 225,915

Distributions

We paid the following distributions per share for the three and nine months ended September 30, 2016 and 2015:

	For the three months ended September 30,		For the nine months ended September 30,	
	2016	2015	2016	2015
Common Stock	\$0.375	\$ 0.375	\$1.125	\$ 1.125
Senior Common Stock	0.2625	0.2625	0.7875	0.7875
Series A Preferred Stock	0.484374	0.484374	1.453124	1.453124
Series B Preferred Stock	0.4688	0.4688	1.4063	1.4063
Series C Preferred Stock	0.2424 (1)	0.4453	1.1330 (1)	1.3359
Series D Preferred Stock	0.4375	—	0.6163	—

(1) We fully redeemed our Series C Preferred Stock on August 19, 2016, and paid all outstanding shareholders a prorated dividend for the month of August.

Table of Contents

Recent Activity

Common Stock ATM Program

During the nine months ended September 30, 2016, we sold 65,000 shares of common stock, raising \$0.9 million in net proceeds under our previous common stock ATM program with Cantor Fitzgerald & Co., or Cantor Fitzgerald. In February 2016, we amended our common ATM program, or the Amended Common ATM, with Cantor Fitzgerald. The amendment increased the amount of shares of common stock that we may offer and sell through Cantor Fitzgerald, to \$160.0 million. All other terms of the common ATM program remained unchanged. During the nine months ended September 30, 2016, we sold an additional 1.1 million shares of common stock, raising \$17.7 million in net proceeds under our Amended Common ATM. As of September 30, 2016, we had a remaining capacity to sell up to \$141.1 million of common stock under the Amended Common ATM.

Preferred Stock ATM Programs

Series A and B Preferred Stock: In February 2016, we entered into an open market sales agreement, or the Series A and B Preferred ATM, with Cantor Fitzgerald, pursuant to which we may, from time to time, offer to sell (i) shares of our 7.75% Series A Cumulative Redeemable Preferred Stock, or the Series A Preferred, and (ii) shares of our 7.50% Series B Cumulative Redeemable Preferred Stock, or the Series B Preferred, having an aggregate offering price of up to \$40.0 million, through Cantor Fitzgerald, acting as sales agent and/or principal. During the nine months ended September 30, 2016, we sold 114,000 shares of our Series B Preferred for net proceeds of \$2.8 million. As of September 30, 2016, we had a remaining capacity to sell up to \$37.2 million of preferred stock under the Series A and B Preferred ATM.

Mezzanine Equity

Series D Preferred Stock: During the nine months ended September 30, 2016, we entered into purchase agreements with certain institutional investors and broker dealers whereby we agreed to sell a total of 2,273,725 shares of our 7.00% Series D Cumulative Redeemable Preferred Stock, par value \$0.001 per share or the Series D Preferred, with a liquidation preference of \$25.00 per share, in registered direct placements. Our total net proceeds from these offerings, after deducting offering expenses, were \$55.1 million. The proceeds were used to redeem \$38.5 million of our Term Preferred Stock, which represents all of our then outstanding shares of such stock, with the remainder used to repay outstanding debt. The Series D Preferred is classified as mezzanine equity in our condensed consolidated balance sheet because it is redeemable at the option of the shareholder upon a change of control of greater than 50% in accordance with ASC 480-10-S99 "Distinguishing Liabilities from Equity," which requires mezzanine equity classification for preferred stock issuances with redemption features which are outside of the control of the issuer. A change in control of our company outside of our control is only possible if a tender offer is accepted by over 90% of our shareholders. All other change in control situations would require input from our Board of Directors. We will periodically evaluate the likelihood that a change of control greater than 50% will take place, and if we deem this probable, we would adjust the Series D Preferred presented in mezzanine equity to their redemption value, with the offset to gain (loss) on extinguishment. We currently believe the likelihood of a change of control greater than 50% is remote.

Series D Preferred Stock ATM: In June 2016, we entered into an open market sales agreement, or the Series D Preferred ATM, with Cantor Fitzgerald, pursuant to which we may, from time to time, offer to sell shares of our Series D Preferred, having an aggregate offering price of up to \$50.0 million, through Cantor Fitzgerald, acting as sales agent and/or principal. During the nine months ended September 30, 2016, we sold 502,000 shares of our Series D Preferred for net proceeds of \$12.5 million. As of September 30, 2016, we had a remaining capacity to sell up to \$37.3 million of Series D Preferred under the Series D Preferred ATM.

Table of Contents

11. Subsequent Events

Distributions

On October 11, 2016, our Board of Directors declared the following monthly distributions for the months of October, November and December of 2016:

Record Date	Payment Date	Common Stock Distributions per Share	Series A Preferred Distributions per Share	Series B Preferred Distributions per Share	Series D Preferred Distributions per Share
October 21, 2016	October 31, 2016	\$ 0.125	\$0.1614583	\$ 0.15625	\$0.1458333
November 17, 2016	November 30, 2016	0.125	0.1614583	0.15625	0.1458333
December 20, 2016	December 30, 2016	0.125	0.1614583	0.15625	0.1458333
Total		\$ 0.375	\$0.4843749	\$ 0.46875	\$0.4375

Senior Common Stock Distributions

Payable to the Holders of Record During the Month of:	Payment Date	Distribution per Share
October	November 7, 2016	\$ 0.0875
November	December 7, 2016	0.0875
December	January 9, 2017	0.0875
Total		\$ 0.2625

Leasing Activity

On October 10, 2016, we entered into a lease amendment with the tenant occupying our Vance, Alabama property. We agreed to fund a \$7.0 million expansion which would add 75,000 square feet to our property, bringing the property to a total of 245,000 square feet. Upon completion of the expansion project, we will enter into a new 10-year lease.

On October 18, 2016, 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 years through September 30, 2022. The lease was originally set to expire on September 30, 2017. The lease provides for prescribed rent escalations over its life, with annualized straight line rents of approximately \$0.8 million. In connection with the extension of the lease and modification of certain terms of the lease, we committed to \$0.3 million in tenant improvements.

Officer Appointment

On October 19, 2016, our Board of Directors appointed Michael Sodo to the office of Chief Financial Officer, effective November 1, 2016.

Table of Contents

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

All statements contained herein, other than historical facts, may constitute "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, or the Exchange Act. These statements may relate to, among other things, future events or our future performance or financial condition. In some cases, you can identify forward-looking statements by terminology such as "may," "might," "believe," "will," "provided," "anticipate," "future," "could," "growth," "plan," "intend," "expect," "seek," "possible," "potential," "likely" or the negative of such terms or comparable terminology. These forward-looking statements involve known and unknown risks, uncertainties and other factors that may cause our business, financial condition, liquidity, results of operations, funds from operations or prospects to be materially different from any future business, financial condition, liquidity, results of operations, funds from operations or prospects expressed or implied by such forward-looking statements. For further information about these and other factors that could affect our future results, please see the captions titled "Forward-Looking Statements" and "Risk Factors" in this report and in our Annual Report on Form 10-K for the year ended December 31, 2015. We caution readers not to place undue reliance on any such forward-looking statements, which are made pursuant to the Private Securities Litigation Reform Act of 1995 and, as such, speak only as of the date made. We undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise, after the date of this Quarterly Report on Form 10-Q.

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

General

We are an externally-advised real estate investment trust, or REIT, that was incorporated under the General Corporation Law of the State of Maryland on February 14, 2003. We focus on acquiring, owning, and managing primarily office and industrial properties. On a selective basis, we may make long term industrial and commercial mortgage loans. Our properties are geographically diversified and our tenants cover a broad cross section of business sectors and range in size from small to very large private and public companies. We actively communicate with buyout funds, real estate brokers and other third parties to locate properties for potential acquisition or to provide mortgage financing in an effort to build our portfolio. We target secondary growth markets that possess favorable economic growth trends, diversified industries, and growing population and employment.

We have historically entered into, and intend in the future to enter into, purchase agreements for real estate having net leases with terms of approximately 7 to 15 years and built in rental rate increases. Under a net lease, the tenant is required to pay all operating, maintenance, repair and insurance costs and real estate taxes with respect to the leased property.

As of October 31, 2016:

- we owned 97 properties totaling 11.0 million square feet in 24 states;
- our occupancy rate was 97.7%;
- the weighted average remaining term of our mortgage debt was 6.4 years and the weighted average interest rate was 4.71%; and
- the average remaining lease term of the portfolio was 7.9 years.

Business Environment

In the United States, vacancy rates have decreased for both office and industrial properties in most markets, as increased user demand has led to improved conditions. In fact, vacancy rates in many markets have been reduced to levels seen at the peak before the most recent recession and rental rates have increased in many primary and secondary markets. This condition has led to a rise in construction activity for both office and industrial properties in many markets; however, vacancy rates in certain secondary and tertiary markets are still higher than pre-recession levels as job growth has yet to return to all areas of the country even though the published unemployment rate has dropped over the past 12 months. Interest rates have been volatile since the beginning of the year and although interest rates are still

relatively low, lenders have increased their required spreads and overall financing costs for fixed rate mortgages appear to be on the rise. At the beginning of the year several research firm surveys reflected that the current real estate cycle may be peaking and that publicly traded real estate investment trusts could be net sellers. Through the first nine months of the year, statistics from reputed international investment sales companies reflect that overall investment volume is reported to be down by as much as 20% compared to the same period in 2015.

Table of Contents

From a more macro-economic perspective, the strength of the global economy and U.S. economy in particular continue to be uncertain with increased volatility due to the recent vote in the United Kingdom to exit the European Union, the oversupply of energy worldwide and an apparent global economic slowdown. In addition, the uncertainty surrounding the ability of the federal government to address its fiscal condition in both the near and long term as well as other geo-political issues has increased domestic and global instability. These developments could cause interest rates and borrowing costs to rise, which may adversely affect our ability to access both the equity and debt markets and could have an adverse effect on our tenants as well.

We continue to focus on re-leasing vacant space, renewing upcoming lease expirations, re-financing upcoming loan maturities, and acquiring additional properties. Currently, we only have one fully vacant building, which is located in Newburyport, Massachusetts, and a total of five partially vacant buildings.

We have three expiring leases in 2017, which accounts for 0.7% of rental income recognized during the nine months ended September 30, 2016 and three expiring leases in 2018, which accounts for 1.3% of rental income recognized during the nine months ended September 30, 2016.

Our available vacant space at September 30, 2016 represents 2.3% of our total square footage and the annual carrying costs on the vacant space, including real estate taxes and property operating expenses, are approximately \$0.7 million. We continue to actively seek new tenants for these properties.

Our ability to make new investments is highly dependent upon our ability to procure external financing. Our principal sources of external financing generally include the issuance of equity securities, long-term mortgage loans secured by properties and borrowings under our line of credit, or the Line of Credit. While lenders' credit standards have tightened, long-term mortgages are readily obtainable. We continue to look to regional banks and insurance companies, in addition to the collateralized mortgage backed securities market, or the CMBS market, to issue mortgages to finance our real estate activities.

In addition to obtaining funds through borrowing, we have been active in the equity markets during the nine months ended September 30, 2016. We have issued shares of both common and preferred stock through our at-the-market programs, or ATM Programs, pursuant to our open market sale agreements with Cantor Fitzgerald, discussed in more detail below and completed an underwritten offering of Series D Preferred.

Recent Developments

2016 Investment Activity

During the nine months ended September 30, 2016, we acquired two properties, which are summarized below (dollars in thousands):

Location	Acquisition Date	Square Footage (unaudited)	Lease Term	Renewal Options	Total Purchase Price	Acquisition Expenses	Annualized GAAP Rent	Debt Issued
Salt Lake City, UT	5/26/2016	107,062	6 Years	2 (3 Years and 2 Years)	\$ 17,000	\$ 105	\$ 1,393	\$9,900
Fort Lauderdale, FL	9/12/2016	119,224	9 Years	2 (5 Years)	23,900	74	1,974	14,100
Total		226,286			\$40,900	\$ 179	\$ 3,367	\$24,000

During 2016, we continued to execute our capital recycling program, whereby we opportunistically sell properties outside of our core markets, and redeploy proceeds to fund property acquisitions located in our target secondary growth markets. During the nine months ended September 30, 2016, we sold four non-core properties, and applied the proceeds towards outstanding debt, and property acquisitions. We will continue to sell non-core properties under advantageous circumstances.

Table of Contents

2016 Financing Activity

During the nine months ended September 30, 2016, we repaid 6 mortgages, collateralized by 12 properties, and issued 5 long-term mortgages, collateralized by 10 properties, which are summarized below (dollars in thousands):

Date of Issuance/Repayment	Issuing Bank	New Debt Issued	Interest Rate	Maturity Date	Principal Balance Repaid	Previous Interest Rate
3/1/2016	Key Bank	\$18,475	LIBOR + 2.35%	(1) 3/1/2023	\$ 21,197	6.14%
4/22/2016	Great Southern Bank	9,530	LIBOR + 2.75%	(2) 4/22/2019	3,667	6.25%
4/28/2016	N/A	N/A	N/A	(3) N/A	22,510,000	6.34%
5/26/2016	Prudential	9,900	4.684%	(4) 6/1/2026	N/A	N/A
9/1/2016	N/A	N/A	N/A	(5) N/A	12,677,000	5.76%
9/12/2016	Union Fidelity Life Insurance Company	14,100	4.25%	(6) 10/5/2026	N/A	N/A
9/30/2016	Huntington Bank	4,000	LIBOR + 2.50%	(7) 9/30/2018	N/A	N/A

We refinanced maturing debt on our Chalfont, Pennsylvania, Big Flats, New York and Franklin and Eatontown, (1) New Jersey properties, which was originally set to mature during second quarter 2016. We entered into an interest rate cap agreement with Key Bank, which caps LIBOR at 3% through March 1, 2019.

We refinanced maturing debt on our Coppell, Texas property, which was originally set to mature during second quarter 2016. We pooled the new mortgage debt with unencumbered properties located in Allen and Colleyville, (2) Texas. We entered into an interest rate cap agreement with Great Southern Bank, which caps LIBOR at 2.5% through April 22, 2019.

We repaid our \$10.7 million mortgage on our Springfield, Missouri property that was originally set to mature on July 1, 2016, and we repaid our \$11.8 million mortgage on our Wichita, Kansas, Clintonville, Wisconsin, Angola, (3) Indiana and Rock Falls, Illinois properties that was originally set to mature on May 5, 2016. We repaid both mortgages using existing cash on hand and borrowings from our line of credit.

(4) We borrowed \$9.9 million to acquire the property in Salt Lake City, Utah.

We repaid our \$12.7 million mortgage on our Lexington, North Carolina, Arlington, Texas and San Antonio, Texas (5) properties that was originally set to mature on December 1, 2016. We repaid this mortgage using existing cash on hand and borrowings from our line of credit.

(6) We borrowed \$14.1 million to acquire the property in Fort Lauderdale, Florida.

We obtained financing for our Maple Heights, Ohio property, which was previously in the unencumbered pool of (7) assets on our line of credit. We entered into an interest rate cap agreement with Huntington Bank, which caps LIBOR at 2.5% through September 30, 2019.

2016 Leasing Activities

We have executed eight leases, which are summarized below (dollars in thousands):

Location	Lease Commencement Date	Square Footage (unaudited)	Lease Term	Renewal Options	Annualized GAAP Rent	Tenant Improvements	Leasing Commissions
Maple Heights, OH	6/1/2016	40,606	(1) 5.2 Years	2 (3 year)	\$ 109	\$ —	\$ 34
Bolingbrook, IL	7/1/2016	13,816	(2) 7.2 Years	1 (5 year)	70	69	28
Richmond, VA	N/A	42,213	(3) 3 Years	N/A	228	—	—

Edgar Filing: GLADSTONE COMMERCIAL CORP - Form 10-Q

Maple Heights, OH	N/A	180,000	(4) 1 Year	N/A	530	60	—
Burnsville, MN	12/1/2016	12,663	(5) 5.3 Years	1 (5 year)	143	—	104
South Hadley, MA	N/A	150,000	(6) 1 Year	1 (1 year)	288	—	7
Bolingbrook, IL	1/2/2017	20,719	(7) 7.3 Years	1 (5 year)	107	204	48
Wichita, KS	N/A	69,287	(8) 5 Years	2 (5 year)	779	250	5

(1) Tenant's lease is for 11.7% of the building. The building is now 63.5% leased.

(2) Tenant's lease is for 24.9% of the building. The building is now 100.0% leased.

Table of Contents

- (3) Tenant extended their current lease for an additional 3 years, expiring December 2019.
- (4) Tenant extended their current lease for an additional year, expiring December 2019. The tenant also exercised their contraction right and downsized their square footage. The building is now 63.5% leased.
- (5) Tenant's lease is for 11.0% of the building. The building is now 80.4% leased.
- (6) Tenant extended their current lease for an additional year, expiring February 2018.
- (7) Tenant's lease is for 37.3% of the building. The building is now 100.0% leased.
- (8) Tenant extended their current lease for an additional 5 years, expiring September 2022.

2016 Equity Activities

Series D Preferred Stock Offering: During the nine months ended September 30, 2016, we entered into purchase agreements with certain institutional investors and broker dealers whereby we agreed to sell a total of 2,273,725 shares of our 7.00% Series D Cumulative Redeemable Preferred Stock, par value \$0.001 per share or the Series D Preferred, with a liquidation preference of \$25.00 per share, in registered direct placements. Our total net proceeds from these offerings, after deducting offering expenses, were \$55.1 million. The proceeds were used to redeem \$38.5 million of our Term Preferred Stock, which represents all of our then outstanding shares of such stock, with the remainder used to repay outstanding debt.

Common Stock ATM Program: During the nine months ended September 30, 2016, we sold 65,000 shares of common stock, raising \$0.9 million in net proceeds under our previous common stock ATM program with Cantor Fitzgerald. In February 2016, we amended our common stock ATM program, or the Amended Common ATM, with Cantor Fitzgerald. The amendment increased the amount of shares of common stock that we may offer and sell through Cantor Fitzgerald, to \$160.0 million. During the nine months ended September 30, 2016, we sold an additional 1.1 million shares of common stock, raising \$17.7 million in net proceeds under our Amended Common ATM. All other terms of the common ATM program remained unchanged. As of September 30, 2016, we had a remaining capacity to sell up to \$141.1 million of common stock under the Amended Common ATM.

Preferred ATM Programs:

Series A and B Preferred Stock: In February 2016, we entered into an open market sales agreement, or the Series A and B Preferred ATM, with Cantor Fitzgerald, pursuant to which we may, from time to time, offer to sell (i) shares of our 7.75% Series A Cumulative Redeemable Preferred Stock, or the Series A Preferred, and (ii) shares of our 7.50% Series B Cumulative Redeemable Preferred Stock, or the Series B Preferred, having an aggregate offering price of up to \$40.0 million, through Cantor Fitzgerald, acting as sales agent and/or principal. During the nine months ended September 30, 2016, we sold 114,000 shares of our Series B Preferred for net proceeds of \$2.8 million. As of September 30, 2016, we had a remaining capacity to sell up to \$37.2 million of preferred stock under the Series A and B Preferred ATM.

Series D Preferred Stock: In June 2016, we entered into an open market sales agreement, or the Series D Preferred ATM, with Cantor Fitzgerald, pursuant to which we may, from time to time, offer to sell shares of our Series D Preferred, having an aggregate offering price of up to \$50.0 million, through Cantor Fitzgerald, acting as sales agent and/or principal. During the nine months ended September 30, 2016, we sold 502,000 shares of our Series D Preferred for net proceeds of \$12.5 million. As of September 30, 2016, we had a remaining capacity to sell up to \$37.3 million of Series D Preferred under the Series D Preferred ATM.

Series C Term Preferred Stock Redemption: During June 2016, we redeemed 1,000,000 shares of our 7.125% Series C Cumulative Term Preferred Stock, or Term Preferred Stock, at a redemption price of \$25.00 per share, plus an amount equal to all accumulated and unpaid dividends. On August 19, 2016, we redeemed the remaining 540,000 outstanding shares of our Term Preferred Stock at a redemption price of \$25.00 per share, plus an amount equal to all accumulated and unpaid dividends. The Term Preferred Stock was originally set to mature in January 2017.

Table of Contents

Diversity of Our Portfolio

Our Adviser seeks to diversify our portfolio to avoid dependence on any one particular tenant, industry or geographic market. By diversifying our portfolio, our Adviser intends to reduce the adverse effect on our portfolio of a single under-performing investment or a downturn in any particular industry or geographic market. For the nine months ended September 30, 2016, our largest tenant comprised only 5.7% of total rental income. The table below reflects the breakdown of our total rental income by tenant industry classification for the three and nine months ended September 30, 2016 and 2015, respectively (dollars in thousands):

Industry Classification	For the three months ended September 30, 2016			2015			For the nine months ended September 30, 2016			2015		
	Rental Revenue	Percentage of Rental Revenue	%	Rental Revenue	Percentage of Rental Revenue	%	Rental Revenue	Percentage of Rental Revenue	%	Rental Revenue	Percentage of Rental Revenue	%
Telecommunications	\$3,384	16.0	%	\$3,200	15.6	%	\$9,943	15.9	%	\$9,528	15.8	%
Healthcare	3,379	15.9		3,302	16.0		10,163	16.2		9,129	15.2	
Automobile	2,639	12.4		2,635	12.8		7,910	12.6		7,907	13.2	
Diversified/Conglomerate Services	1,987	9.4		1,186	5.7		5,929	9.4		3,524	5.9	
Diversified/Conglomerate Manufacturing	1,205	5.7		1,099	5.3		3,504	5.6		3,152	5.3	
Electronics	1,082	5.1		1,139	5.5		3,246	5.2		3,539	5.9	
Information Technology	946	4.5		572	2.8		2,261	3.6		780	1.3	
Personal, Food & Miscellaneous Services	892	4.2		1,576	7.6		2,677	4.3		4,730	7.9	
Chemicals, Plastics & Rubber	775	3.7		789	3.8		2,335	3.7		2,367	3.9	
Containers, Packaging & Glass	682	3.2		521	2.5		2,019	3.2		1,563	2.6	
Personal & Non-Durable Consumer Products	658	3.1		656	3.2		1,970	3.1		1,972	3.3	
Machinery	644	3.0		772	3.7		2,007	3.2		2,317	3.9	
Banking	614	2.9		563	2.7		1,839	2.9		1,142	1.9	
Childcare	556	2.6		556	2.7		1,667	2.7				