GLADSTONE COMMERCIAL CORP
Form 10-Q
May 06, 2008

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

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2008**
OR

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

COMMISSION FILE NUMBER: 0-50363
GLADSTONE COMMERCIAL CORPORATION
(Exact name of registrant as specified in its charter)

MARYLAND	**02-0681276**
(State or other jurisdiction of incorporation or organization)	*(I.R.S. Employer Identification No.)*

1521 WESTBRANCH DRIVE, SUITE 200
MCLEAN, VIRGINIA 22102
(Address of principal executive office)
(703) 287-5800
(Registrant s telephone number, including area code)

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

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 o	Accelerated filer þ	Non-accelerated filer o	Smaller reporting company o
		(Do not check if a smaller reporting company)	

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

The number of shares of the registrant s Common Stock, $0.001 par value, outstanding as of May 6, 2008 was 8,565,264.

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GLADSTONE COMMERCIAL CORPORATION
CONSOLIDATED BALANCE SHEETS
(Unaudited)

	March 31, 2008	December 31, 2007
ASSETS		
Real estate, net of accumulated depreciation of $17,842,267 and $15,738,634, respectively	$ 353,335,334	$ 324,761,772
Lease intangibles, net of accumulated amortization of $8,445,057 and $7,560,928, respectively	31,079,739	28,989,556
Mortgage notes receivable	10,000,000	10,000,000
Cash and cash equivalents	1,335,884	1,356,408
Restricted cash	2,409,065	1,914,067
Funds held in escrow	1,538,551	1,401,695
Deferred rent receivable	5,575,368	5,094,799
Deferred financing costs, net of accumulated amortization of $2,433,815 and $2,184,492, respectively	4,191,740	4,405,129
Prepaid expenses and other assets	1,717,397	979,263
TOTAL ASSETS	$ 411,183,078	$ 378,902,689
LIABILITIES AND STOCKHOLDERS EQUITY		
LIABILITIES		
Mortgage notes payable	$ 201,736,050	$ 202,120,471
Short-term loan and borrowings under line of credit	59,050,000	24,400,000
Deferred rent liability	3,736,644	3,933,035
Asset retirement obligation liability	2,101,655	1,811,752
Accounts payable and accrued expenses	693,112	778,949
Due to adviser	788,428	784,301
Obligation under capital lease	225,067	
Rent received in advance, security deposits and funds held in escrow	3,302,629	2,706,113
Total Liabilities	271,633,585	236,534,621
STOCKHOLDERS EQUITY		
Redeemable preferred stock, $0.001 par value; $25 liquidation preference; 2,300,000 shares authorized and 2,150,000 shares issued and outstanding	2,150	2,150
Common stock, $0.001 par value, 17,700,000 shares authorized and 8,565,264 shares issued and outstanding	8,565	8,565

Additional paid in capital	170,640,979	170,640,979
Notes receivable employees	(2,769,791)	(2,769,923)
Distributions in excess of accumulated earnings	(28,332,410)	(25,513,703)
Total Stockholders Equity	139,549,493	142,368,068
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$ 411,183,078	$ 378,902,689

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

GLADSTONE COMMERCIAL CORPORATION
CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)

	For the three months ended March 31,	
	2008	2007
Operating revenues		
Rental income	$ 9,189,465	$ 7,078,036
Interest income from mortgage notes receivable	238,297	250,000
Tenant recovery revenue	85,719	55,735
Total operating revenues	9,513,481	7,383,771
Operating expenses		
Depreciation and amortization	2,987,760	2,417,812
Property operating expenses	241,568	174,176
Base management fee	431,868	482,044
Incentive fee	704,667	585,768
Administration fee	212,196	207,018
Professional fees	97,662	149,431
Insurance	41,797	58,634
Directors fees	54,250	54,250
Stockholder related expenses	126,423	99,617
Asset retirement obligation expense	30,468	28,160
General and administrative	14,631	40,351
Total operating expenses before credit from Adviser	4,943,290	4,297,261
Credit to incentive fee	(562,355)	(585,768)
Total operating expenses	4,380,935	3,711,493
Other income (expense)		
Interest income from temporary investments	9,548	229,016
Interest income employee loans	52,144	60,422
Other income	9,296	8,414
Interest expense	(3,753,604)	(2,514,461)
Total other expense	(3,682,616)	(2,216,609)
Income from continuing operations	1,449,930	1,455,669
Discontinued operations		

Loss from discontinued operations		(33,228)		(4,001)
Net realized income from foreign currency transactions				7
Taxes refunded on sale of real estate				78,667
Total discontinued operations		(33,228)		74,673
Net income		1,416,702		1,530,342
Dividends attributable to preferred stock		(1,023,437)		(1,023,437)
Net income available to common stockholders	$	393,265	$	506,905
Earnings per weighted average common share basic & diluted				
Income from continuing operations (net of dividends attributable to preferred stock)	$	0.05	$	0.05
Discontinued operations		0.00		0.01
Net income available to common stockholders	$	0.05	$	0.06
Weighted average shares outstanding- basic & diluted		8,565,264		8,565,264

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

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GLADSTONE COMMERCIAL CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

	For the three months ended March 31,	
	2008	2007
Cash flows from operating activities:		
Net income	$ 1,416,702	$ 1,530,342
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	2,987,760	2,417,812
Amortization of deferred financing costs	249,323	164,462
Amortization of deferred rent asset and liability	(133,017)	(133,017)
Asset retirement obligation expense	30,468	28,160
Increase in prepaid expenses and other assets	(76,011)	(119,112)
Increase in deferred rent receivable	(543,943)	(370,227)
(Decrease) increase in accounts payable, accrued expenses, and amount due adviser	(81,710)	289,942
Increase in rent received in advance	101,518	79,357
Net cash provided by operating activities	3,951,090	3,887,719
Cash flows from investing activities:		
Real estate investments	(33,167,003)	(41,778,821)
Increase in funds held in escrow related to acquisition	(762,123)	
Net payments to lenders for reserves held in escrow	(547,624)	(214,107)
Increase in restricted cash	(494,998)	(129,799)
Deposits on future acquisitions	(1,300,000)	(610,000)
Deposits applied against real estate investments	1,400,000	460,000
Net cash used in investing activities	(34,871,748)	(42,272,727)
Cash flows from financing activities:		
Borrowings under mortgage notes payable		13,775,000
Principal repayments on mortgage notes payable	(384,421)	(194,961)
Principal repayments on employee notes receivable from sale of common stock	132	25,012
Borrowings from line of credit	36,150,000	
Repayments on line of credit	(1,500,000)	
Increase in reserves from tenants	548,856	346,542
Increase in security deposits	356,910	
Payments for deferred financing costs	(35,934)	(378,745)
Dividends paid for common and preferred	(4,235,409)	(4,106,932)
Net cash provided by financing activities	30,900,134	9,465,916

Net decrease in cash and cash equivalents	(20,524)	(28,919,092)
Cash and cash equivalents, beginning of period	1,356,408	36,005,686
Cash and cash equivalents, end of period	$ 1,335,884	$ 7,086,594
NON-CASH INVESTING ACTIVITIES		
Increase in asset retirement obligation	$ 259,435	$ 92,143

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

GLADSTONE COMMERCIAL CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Organization and Significant Accounting Policies

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

Subsidiaries

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

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

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

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

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

Interim financial information

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

Investments in real estate

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

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

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

The Company allocates purchase price to the fair value of the tangible assets of an acquired property by valuing the property as if it were vacant. The as-if-vacant value is allocated to land, building, and tenant improvements based on management s determination of the relative fair values of these assets. Real estate depreciation expense on these tangible assets was $2,103,633 and $1,593,790 for the three months ended March 31, 2008 and 2007, respectively.

Above-market and below-market in-place lease values for owned properties are recorded based on the present value (using an interest rate which reflects the risks associated with the leases acquired) of the difference between (i) the contractual amounts to be paid pursuant to the in-place leases and (ii) management s estimate of fair market lease rates for the corresponding in-place leases, measured over a period equal to the remaining non-cancelable term of the lease. The capitalized above-market lease values, included in the accompanying balance sheet as part of deferred rent receivable, are amortized as a reduction of rental income over the remaining non-cancelable terms of the respective leases. Total amortization related to above-market lease values was $63,374 for both the three months ended March 31, 2008 and 2007. The capitalized below-market lease values, included in the accompanying balance sheet as deferred rent liability, are amortized as an increase to rental income over the remaining non-cancelable terms of the respective leases. Total amortization related to below-market lease values was $196,391 for both the three months ended March 31, 2008 and 2007.

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

The value of in-place leases and unamortized lease origination costs are amortized to expense over the remaining term of the respective leases, which generally range from five to twenty years. The value of customer relationship intangibles, which is the benefit to the Company resulting from the likelihood of an existing tenant renewing its lease, are amortized to expense over the remaining term and any anticipated renewal periods in the respective leases, but in no event does the amortization period for intangible assets exceed the remaining depreciable life of the building. Should a tenant terminate its lease, the unamortized portion of the above-market and below-market lease values, in-place lease values, unamortized lease origination costs and customer relationship intangibles will be charged to expense. Total amortization expense related to these intangible assets was $884,129 and $824,017 for the three months ended March 31, 2008 and 2007, respectively.

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

	March 31, 2008		December 31, 2007	
	Lease Intangibles	Accumulated Amortization	Lease Intangibles	Accumulated Amortization
In-place leases	$ 13,475,625	$ (3,816,500)	$ 12,660,732	$ (3,414,868)
Leasing costs	9,467,919	(2,331,187)	9,290,026	(2,114,233)
Customer relationships	16,581,252	(2,297,370)	14,599,726	(2,031,827)
	$ 39,524,796	$ (8,445,057)	$ 36,550,484	$ (7,560,928)

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

Year	Estimated Amortization Expense
2008	$2,854,673
2009	3,678,591
2010	3,590,188
2011	3,399,399
2012	2,998,170

Impairment

Investments in Real Estate

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

Provision for Loan Losses

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

Cash and cash equivalents

The Company considers all short-term, highly liquid investments that are both readily convertible to cash and have a maturity of three months or less at the time of purchase to be cash equivalents; except that any such investments purchased with funds held in escrow or similar accounts are classified as restricted cash. Items classified as cash equivalents include commercial paper and money-market funds. All of the Company s cash and cash equivalents at March 31, 2008 were held in the custody of one financial institution, and the Company s balance at times may exceed federally insurable limits. The Company mitigates this risk by depositing funds with major financial institutions.

Restricted cash

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

Funds held in escrow

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

Deferred financing costs

Deferred financing costs consist of costs incurred to obtain financing, including legal fees, origination fees, and administrative fees. The costs are deferred and amortized using the straight-line method, which approximates the effective interest method, over the term of the financing secured. The Company made payments of $35,934 and $378,745 for deferred financing costs during the three months ended March 31, 2008 and 2007, respectively. Total amortization expense related to deferred financing costs was $249,323 and $164,462 for the three months ended March 31, 2008 and 2007, respectively.

Prepaid expenses and other assets

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

Obligation under capital lease

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

Revenue recognition

Rental revenue includes rents that each tenant pays in accordance with the terms of its respective lease reported on a straight-line basis over the non-cancelable term of the lease. Certain of the Company s leases currently contain rental increases at specified intervals, and straight-line basis accounting requires the Company to record an asset, and include in revenues, deferred rent receivable that will be received if the tenant makes all rent payments required through the expiration of the initial term of the lease. Deferred rent receivable in the accompanying balance sheet includes the cumulative difference between rental revenue as recorded on a straight line basis and rents received from the tenants in accordance with the lease terms, along with the capitalized above-market lease values of certain acquired properties. Accordingly, the Company determines, in its judgment, to what extent the deferred rent receivable applicable to each specific tenant is collectible. The Company reviews deferred rent receivable, as it relates to straight line rents, on a quarterly basis and takes into consideration the tenant s payment history, the financial condition of the tenant, business conditions in the industry in which the tenant operates and economic conditions in the area in which the property is located. In the event that the collectibility of deferred rent with respect to any given tenant is in doubt, the Company records an increase in the allowance for uncollectible accounts or records a direct write-off of the specific rent receivable, which would have an adverse effect on the net income for the year in which the reserve is increased or the direct write-off is recorded and would decrease total assets and stockholders equity. No such reserves have been recorded as of March 31, 2008.

Management considers its loans and other lending investments to be held-for-investment. The Company reflects held-for-investment investments at amortized cost less allowance for loan losses, acquisition premiums or discounts, and deferred loan fees. On occasion, the Company may acquire loans at small premiums or discounts based on the credit characteristics of such loans. These premiums or discounts are recognized as yield adjustments over the lives of the related loans. Loan origination fees, as well as direct loan origination costs, are also deferred and recognized over the lives of the related loans as yield adjustments. If loans with premiums, discounts, or loan origination fees are prepaid, the Company immediately recognizes the unamortized portion as a decrease or increase in the prepayment gain or loss. Interest income is recognized using the effective interest method applied on a loan-by-loan basis. Prepayment penalties or yield maintenance payments from borrowers are recognized as additional income when received.

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

Income taxes

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

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

Segment information

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

Foreign currency transactions

The Company purchased two properties in Canada in October of 2004. These properties were classified as held for sale as of June 30, 2006, and were sold in July 2006. All gains and losses from foreign currency transactions are reflected in discontinued operations in the Company s consolidated financial statements. The Company had a bank account in Canada, which was closed in December 2007. The cash account was re-valued at each balance sheet date to reflect the then current exchange rate. The gains or losses from the valuation of the cash were recorded on the income statement as a realized gain or loss. A realized foreign currency gain of $7 was recorded for the three months ended March 31, 2007. There were no realized foreign currency gains or losses recorded for the three months ending March 31, 2008.

Asset retirement obligations

In March of 2005, the FASB issued Interpretation No. 47, Accounting for Conditional Asset Retirement Obligations (FIN 47). FIN 47 requires an entity to recognize a liability for a conditional asset retirement obligation when incurred if the liability can be reasonably estimated. FIN 47 clarifies that the term Conditional Asset Retirement Obligation refers to a legal obligation (pursuant to existing laws or by contract) to perform an asset retirement activity in which the timing and/or method of settlement are conditional on a future event that may or may not be within the control of the entity. FIN 47 also clarifies when an entity would have sufficient information to reasonably estimate the fair value of an asset retirement obligation. The Company has accrued a liability and corresponding increase to the cost of the related properties for disposal related to all properties constructed prior to 1985 that have, or may have, asbestos present in the building. The Company accrued a liability during the three months ended March 31, 2008 of $259,435 related to properties acquired during the period. The Company also recorded expense of $30,468 and $28,160, during the three months ended March 31, 2008 and 2007, respectively, related to the cumulative accretion of the obligation.

Real estate held for sale and discontinued operations

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

Recently Issued Accounting Pronouncements

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements (SFAS 157). SFAS 157 defines fair value, establishes a framework for measuring fair value in GAAP and expands disclosures about fair value measurements. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company has only partially adopted the provisions of SFAS 157 because of the issuance of FSP SFAS 157-2 (the FSP), which allows companies to delay the effective date of SFAS 157 for non-financial assets and liabilities. The FSP permits companies that have not already issued either interim or annual financial statements reflecting the adoption of SFAS 157 to delay the effective date of SFAS 157 for non-financial assets and non-financial liabilities, expect for items that are recognized or disclosed at fair value in the financial statements on a recurring basis. The partial adoption had no impact on the Company s results of operations.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities (SFAS 159). SFAS 159 allows entities to measure at fair value many financial instruments and certain other assets and liabilities that are not otherwise required to be measured at fair value. SFAS 159 is effective for fiscal years beginning after November 15, 2007. The Company adopted SFAS 159 effective for the fiscal year beginning January 1, 2008, and the adoption had no impact on the Company s results of operations.

In December 2007, the FASB issued SFAS No. 141 (revised 2007), Business Combinations, SFAS No. 141(R), which replaces SFAS No. 141, Business Combinations (SFAS 141R). SFAS 141R significantly changes the accounting for acquisitions involving business combinations, as it requires that the assets and liabilities of all business combinations be recorded at fair value, with limited exceptions. SFAS 141R also requires that all expenses related to the acquisition be expensed as incurred, rather than capitalized into the cost of the acquisition as had been the previous accounting under SFAS 141. SFAS 141R is effective on a prospective basis for all business combinations for which the acquisition date is on or after the beginning of the first annual period subsequent to December 15, 2008.

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

In March 2008, the FASB issued SFAS No. 161, Disclosures about Derivative Instruments and Hedging Activities (SFAS 161), which is intended to help investors better understand how derivative instruments and hedging activities affect an entity s financial position, financial performance and cash flows through enhanced disclosure requirements. The enhanced disclosures primarily surround disclosing the objectives and strategies for using derivative instruments by their underlying risk as well as a tabular format of the fair values of the derivative instruments and their gains and losses. SFAS 161 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008. The Company does not believe the adoption of this pronouncement will have a material impact on its results of operations.

Use of estimates

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

Reclassifications

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

2. Management Advisory Fee

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

Amended Advisory Agreement

The Amended Advisory Agreement provides for an annual base management fee equal to 2% of the Company s total stockholders equity, less the recorded value of any preferred stock, and an incentive fee based on funds from operations (FFO). For the three months ended March 31, 2008 and 2007, the Company recorded a base management fee of $431,868 and $482,044, respectively. For purposes of calculating the incentive fee, FFO includes any realized capital gains and capital losses, less any dividends paid on preferred stock, but FFO does not include any unrealized capital gains or losses. The incentive fee rewards the Adviser if the Company s quarterly FFO, before giving effect to any incentive fee (pre-incentive fee FFO), exceeds 1.75%, or 7% annualized, (the hurdle rate) of total stockholders equity, less the recorded value of any preferred stock. The Adviser receives 100% of the amount of the pre-incentive fee FFO that exceeds the hurdle rate, but is less than 2.1875% of the Company s pre-incentive fee FFO. The Adviser also receives an incentive fee of 20% of the amount of the Company s pre-incentive fee FFO that exceeds 2.1875%. For the three months ended March 31, 2008 and 2007, the Company recorded an incentive fee of $704,667 and $585,768 offset by a credit related to an unconditional and irrevocable voluntary waiver issued by the Adviser of $562,355 and $585,768, for a net incentive fee for the three months ended March 31, 2008 and 2007 of $142,312 and $0, respectively. The board of directors of the Company accepted the Adviser s offer to waive a portion of the incentive fee for the three months ended March 31, 2008 and the offer to waive the entire incentive fee for the three months ended March 31, 2007 in order to support the current level of distributions to the Company s stockholders.

Administration Agreement

Under the Administration Agreement, the Company pays separately for its allocable portion of the Administrator s overhead expenses in performing its obligations including, but not limited to, rent for employees of the Administrator, and its allocable portion of the salaries and benefits expenses of its chief financial officer, chief compliance officer, controller, treasurer and their respective staffs. The amount of overhead expenses allocated to the Company is determined by calculating the percentage of total assets of the Company to the total assets managed by the Administrator. For the three months ended March 31, 2008 and 2007, the Company recorded an administration fee of $212,196 and $207,018, respectively.

3. Earnings per Common Share

The following tables set forth the computation of basic and diluted earnings per share for the three months ended March 31, 2008 and 2007:

	For the three months ended March 31,	
	2008	2007
Net income available to common stockholders	$ 393,265	$ 506,905
Denominator for basic & diluted weighted average shares	8,565,264	8,565,264
Basic & diluted earnings per common share	$ 0.05	$ 0.06

4. Real Estate

A summary of the 56 properties held by the Company as of March 31, 2008 is as follows:

Date Acquired	Location	Square Footage	Property Description	Net Real Estate