HILLIARD LYONS

Real Estate Investment Trusts
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August 1, 2017

COMPANY UPDATE

Gladstone Commercial Corp.

GOOD -- NASDAQ – Neutral-3

Second Quarter Earnings

Investment Highlights

- Last night after the close, GOOD reported Q2 FFO of $0.37 a share, two cents below our estimate. The quarter was a little worse than we had expected with revenue a little light and expenses a little higher. We are likely to adjust our previous full year estimate of $1.57 a share due to the Q2 shortfall, although we will wait until after the 8:30 earnings call before making any adjustments. The company added additional property purchases subsequent to quarter end, as well as completing an equity underwriting.
- GOOD management has made its first 2017 investment in Q2, following a Q1 sale. With the higher share price we anticipate that new investments will continue. We continue to anticipate some fine-tuning of the portfolio, with potential divestitures of some non-core properties given the high prices being paid for properties. We expect that GOOD management will remain disciplined in its acquisition strategy and not overpay for properties, and this is a major reason why we see asset sales, as well as new investment. The current high share price should allow for access to equity capital at attractive prices.
- We will wait for the 8:30 conference call before making any changes and at this point our rating for GOOD remains Neutral, with the share price above our preferred buying range. While the current price offers management an attractive time to sell equity, we would prefer to wait until a price pullback or after an offering that could potentially drive the share price down before becoming more positive on the shares.

Key Metrics

GOOD - NASDAQ - 7/31/17		$21.28
2-3 Year Price Target		N/A
52-Week Range	$16.02 -	$23.35
Shares Outstanding (mm)		26.1
Market Cap. ($mm)		$555.4
1-Mo. Average Daily Volume		36,512
Institutional Ownership		32.0%
Debt/Total Capital Jun-17		45.0%
Est 3-year FFO Growth Rate		1.0%
Est 3-year Dividend Growth Rate		0.0%
Book Value		$10.67
Annual Dividend Rate		$ 1.50
Dividend Yield		7.05%
Est. Fixed Charge Coverage		2.5X

FFO

	2016	Prior 2017E	2017E		Prior 2018E	Current 2018E
1Q	$0.39	--	$0.38	A	$0.40	$0.40
2Q	$0.39	--	$0.37	A	$0.41	$0.41
3Q	$0.39	$0.40	$0.40		$0.42	$0.42
4Q	$0.38	$0.40	$0.40		$0.43	$0.43
Year	$1.55	$1.57	$1.55		$1.65	$1.65
P/E	13.7x		13.7x			12.9x

Note that quarters may not add due to rounding

Revenue ($mm)

	2016	Prior 2017E	Current 2017E		Prior 2018E	Current 2018E
1Q	$21.5	--	$22.3	A	$25.5	$25.5
2Q	$21.2	--	$22.9	A	$26.1	$26.1
3Q	$21.6	$23.9	$23.9		$26.9	$26.9
4Q	$22.1	$24.8	$24.8		$27.6	$27.6
Year	$86.4	$94.0	$93.9		$106.1	$106.1

Company Description: *Gladstone Commercial Corp., headquartered in McLean, VA, is a real estate investment trust (REIT) that is focused on investments in industrial and commercial properties and mortgage loans, primarily to small to medium sized businesses.*

Note Important Disclosures on Pages 6-7.
Note Analyst Certification on Page 6.

Second Quarter Review

Total operating revenues were $22.9 million, compared to $21.2 million in Q2 ’16, up 7.6% year over year (please see table on page 3) as the company made one new investment and completed a property expansion. Rental revenue rose 7.6% to $22.5 million. Tenant reimbursement rose 9.0% to $0.39 million.

Property level operating expenses rose 5.0% to $1.5 million from $1.4 million. Gladstone’s fees are divided between base, administration and incentive fees. There was a 41.0% rise year-over-year in base management fees to $1.21 million. In the 2017 second quarter, the incentive fee was $0.55 million, compared to $0.66 million in the previous year. G&A expenses were down 5.6% at $0.58 million. We note that due to GOOD’s outside management structure, G&A expense is typically small. Total operating expenses were up 9.7% year-over-year.

EBITDA for Q2 was $18.4 million compared to $17.2 million in Q2 ‘16, a 7.1% increase. Interest expense fell 14.4% to $5.9 million from $6.9 million in the year earlier quarter with slightly lower debt levels and lower interest rates.

Net income available to common shareholders was a loss of $2.0 million versus a loss of $0.6 million, although this tends to be a somewhat useless number, due to its insignificant amount and that it shows how little of GOOD’s distribution is likely to be taxed to shareholders. Most of GOOD’s dividend is typically a return of capital, which is a function of most of GOOD’s cash flow being sheltered on a net income basis by depreciation and amortization expense, which are non-cash expenses. This provides investors with an even higher after tax return on this investment when taxes are eventually paid on the reduced cost basis when shares are sold. Preferred dividend payments rose year-over-year to $2.7 million from $1.5 million. What management calls “core” funds from operations, which exclude real estate gains and acquisition-related expenses, were $9.8 million in this year’s second quarter versus $9.1 million last year. FFO per share was $0.375 versus $0.385, on more shares outstanding (up 11.0%).

The leverage on GOOD’s balance sheet has moved down a little since yearend due to recent investment, and it now stands at approximately 1.53x, compared to 1.64x debt-to-equity (please see page 4) at yearend. The company went from having a $64.1 million balance on its credit line at the end of 2016 to having $62.4 million at the end of Q2 ‘17. Mortgage debt fell to $422.4 million from $445.3 million at yearend. As noted earlier, GOOD completed one acquisition during the quarter, a 60,000 square foot single tenant office building in a suburb of Philadelphia, PA for $15.5 million. The property is leased to a publicly-traded company with a remaining term of 8.5 years and the company assumed an existing 3.55% lease with 8.8 years remaining on it. While management did not offer a cap rate on the purchase we expect it was around 7%. The company also completed a 75,000 square foot expansion on an existing property with an average cap rate of 10.4% on the 10-year lease on the expansion. The cost of the expansion was $6.6 million. Subsequent to quarter-end the company added a 300,000 square foot industrial building purchased for $26.4 million at an average cap rate of 6.4%, The property is leased to the federal government, so is a credit tenant, and not the company’s usual type of tenant, thus the lower than typical cap rate for the property. The company also closed a new 10-year mortgage in conjunction with the purchase at a fixed rate of 3.75%, locking in a more than 2.5% spread on the purchase. Subsequent to quarter end the company signed a 5 year 10-month extension with an existing tenant pushing the lease term through 2028 and added a $26.4 million 100%-leased industrial property leased to one tenant on a 15-plus year lease and bought a 100%-leased 3-building office complex in Orlando, FL on a nearly 9-year lease. No financials were offered on these purchases

On the capital market front, the company issued $6.7 million in new mortgage debt in addition to the assumed debt, as well as issuing 735,882 shares of common stock and 185,359 shares of preferred under its “at the market” (ATM) stock sale program raising $21.3 million. Subsequent to quarter end, GOOD sold 1.3 million shares in an underwritten offer for approximately $26 million after offering expenses and raised an additional $13.5 million through sales of common and preferred under its ATM.

Quarterly Income Statement

	2nd Q 17	2nd Q 16	% Change
Rental Revenue	$22,478,000	$20,890,000	7.6%
Tenant Recovery Revenue	389,000	357,000	9.0%
Interest Income from Mortgage Note Receivable	0	0	
Total Operating Revenues	22,867,000	21,247,000	7.6%
Property Operating Expenses	1,505,000	1,434,000	5.0%
Base Management Fee	1,207,000	856,000	41.0%
Administration Fee	340,000	370,000	-8.1%
Incentive Fee	551,000	655,000	-15.9%
Professional Fees	0	0	0.0%
Impariment charge	253,000	0	
Shareholder Related Expenses	0	0	0.0%
Asset Retirement Obligation Expense	0	0	0.0%
Stock Option Compensation Expense	0	0	0.0%
Due Diligence Expense	0	117,000	
Director Fees	0	0	0.0%
General and Administrative Expenses	575,000	609,000	-5.6%
Total Operating Expenses	4,431,000	4,041,000	9.7%
Credit to Incentive Fee	0	0	
EBITDA	18,436,000	17,206,000	7.1%
Interest Expense	5,935,000	6,931,000	-14.4%
Depreciation and Amortization Expenses	9,926,000	9,205,000	7.8%
Gain on sale of assets	0	0	
Interest Income - Employee Loans	0	0	
Other Income (expense)	0	0	
Discontinued Operations (loss)	(1,914,000)	(187,000)	0.0%
Net Income	$661,000	$883,000	-25.1%
Preferred Dividends	$2,686,000	$1,514,000	77.4%
Net Income Available to Common Shareholders	($2,025,000)	($631,000)	220.9%
Net EPS (diluted)	($0.08)	($0.03)	189.2%
Avg. Shares Outstanding (diluted)	26,060,060	23,484,507	11.0%

Funds From Operations	2nd Q 17	2nd Q 16	
Net Income Available to Common Shareholders	($2,025,000)	($631,000)	220.9%
Depreciation and Amortization (incl. discontinued op	9,926,000	9,205,000	7.8%
Less Gain on Sale of Real Estate (net of taxes)	1,866,000	508,000	
Total Funds From Operations	**$9,767,000**	**$9,082,000**	7.5%
FFO Per Share	**$0.375**	**$0.387**	-3.1%

Source: Company reports.

Condensed Balance Sheet

	June 30, 2017	December 31, 2016
Real Estate (Net of Depreciation)	**$679,726,000**	**$690,088,000**
Mortgage Note Receivable	**0**	**0**
Lease Intangibles (net)	101,035,000	105,553,000
Real estate assets & related held for sale	4,208,000	9,562,000
Cash and Cash Equivalents	5,014,000	4,658,000
Restricted Cash	2,777,000	3,030,000
Funds Held in Escrow	4,605,000	6,806,000
Interest Receivable - Mortgage Note	0	0
Interest Receivable - Officers	0	0
Deferred Rent Receivable	28,401,000	29,725,000
Deferred Financing Cost	0	0
Prepaid Expenses	0	0
Deposits on Real Estate	0	0
Other Assets	5,807,000	2,320,000
Total Assets	**$831,573,000**	**$851,742,000**
Mortgage Note Payable	**$422,398,000**	**$445,278,000**
Borrowings under Line of Credit/Term loan	**$62,383,000**	**$64,117,000**
Deferred Rent Liability	14,581,000	12,647,000
Asset Retirement Obligation Liability	3,105,000	3,406,000
Accounts Payable and Accrued Expenses	3,781,000	5,891,000
Due to Adviser	2,104,000	2,075,000
Other Liabilities related to assets for sale	0	1,041,000
Rent Received / Security Deposits / Other	6,805,000	6,667,000
Total Liabilities	515,157,000	541,122,000
Preferrd, Senior common Stock	77,615,000	70,746,000
Common Stock	26,000	25,000
Additional Paid in Capital	481,322,000	463,436,000
Other	179,000	0
Distribution in Excess of Accumulated Earnings	(242,726,000)	(223,587,000)
Total Shareholders' Equity	**$316,416,000**	**$310,620,000**
Total Liabilities and Shareholders' Equity	**$831,573,000**	**$851,742,000**

Balance Sheet Ratio Analysis	June 30, 2017	December 31, 2016
Investments (net) as % of Assets	81.7%	81.0%
Cash & Equiv. and Restricted Cash as % of Assets	0.9%	0.9%
Debt to Equity	153.2%	164.0%
Total Liabilities as % of Assets	61.9%	63.5%
Shareholders' Equity as % of Assets	38.1%	36.5%

Source: Company reports.

First Take

GOOD's numbers were slightly below our expectations on the top line, while also being above our expectations on the cost front. Further, the company issued a significant amount of stock during the quarter, resulting in more dilution than we modelled, thus the lower per share numbers. Acquisition activity had been relatively staid through the first two quarters, but has picked up significantly since the end of the second quarter. These purchases illustrate the reason for all of the equity raising during the quarter, and with all of those purchases are indicative of why the company issued all of the stock. As a result, the dilutive impact is likely to be gone after Q3. Management has been using the ATM program to raise capital through the sale of both common and preferred stock, which should allow ongoing raises of investment capital. With the common shares sitting near all-time highs we would expect management to continue to raise capital through the sale of common shares. The company added the one property discussed previously to its portfolio, finished the property expansion and added two more large properties to its portfolio subsequent to quarter end. As additional properties are added it puts the company on a better future path from an earnings perspective as these new properties begin to deliver to the bottom line. We anticipate that management will continue to fine-tune its portfolio, selling off some properties, while adding others. We will wait until the conference call at 8:30 this morning before making any changes to our estimates. At this point our Neutral rating is retained, with the company's shares sitting above our preferred buying range.

Dividend

As we anticipated, GOOD management chose not to implement a dividend increase in 2016 or so far in 2017. With the dividend only barely covered by FFO we had not anticipated any near term increases in the dividend until the company's payout ratio declined and we anticipate that lack of dividend increases will continue into the foreseeable future. The dividend has remained at $1.50 a share annualized, paid monthly and we anticipate it staying there for several more years.

Suitability

GOOD has a suitability rating of 3 on our 1-4 scale. We find the company to have a diversified portfolio of properties with a long list of tenants and relatively long lease terms. Further, the company's occupancy rate is relatively high and the company's lease rollovers are limited over the next several years. On the other hand, the company's balance sheet is more levered than many of its peers, with a higher level of debt on its properties, leading to the lower suitability rating than many of the other REITs we follow.

Risk Factors for Gladstone Capital

There are a variety of risk factors investors should consider when considering investment in Gladstone Commercial. We believe these risk factors include:

Interest Rate Risk – Like all REITs, GOOD is interest rate sensitive. If short term interest rates were to rise, the spread between the company's return yield and its cost of capital could shrink.

Asset Size – Gladstone Commercial, with market capitalization of approximately $555 million, is one of the smaller REITs tracked by NAREIT. As such, it could be difficult to compete against other larger REITs for property acquisitions and in its attempts to raise capital.

Execution Risk – Gladstone Commercial's unique acquisition strategy makes the company more dependent on the skills of David Gladstone and his management team, more so than other more "traditional" REITs in our opinion.

Capital Constraint Risk – With share prices below the peer group on both the company's common and preferred stock, the company may be constrained in their ability to complete future deals due to a higher cost of capital. Further, if management does decide to undertake an offering to grow, dilution is likely to be fairly significant, which could easily result in GOOD missing our estimates.

Annual yield is calculated by dividing the distribution amount by the current market price of the security. For US income tax purposes, the Company may classify all or a portion of its distributions as dividends or other non-dividend distributions. Note that for some investors, for US income tax purposes all or a portion of the Company's 2016 dividend or distribution was treated as return of capital and not as "dividend income" as reflected on the IRS Form 1099-Div for the 2016 tax year. The Company generally makes a final determination regarding the proper tax treatment of distributions after calendar year end. We urge each shareholder to consult with his or her own tax advisor to determine the tax consequences of the distributions received, including any state, local or foreign tax considerations.

Additional information is available upon request.

Analyst Certification

I, John M. Roberts, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject company(ies) and its (their) securities. I also certify that I have not been, am not, and will not be receiving direct or indirect compensation in exchange for expressing the specific recommendation(s) in this report.

Important Disclosures

Gladstone Investment Corporation (GAIN - $9.68; rated Neutral by Hilliard Lyons), Gladstone Commercial Corporation, Gladstone Land Corp. (LAND - $12.09; rated Long-term Buy) and Gladstone Capital Corporation (GLAD - $9.93; rated Neutral) share the same management and board.

Hilliard Lyons' analysts receive bonus compensation based on Hilliard Lyons' profitability. They do not receive direct payments from investment banking activity.

The author of this report or members of his household have a long position in Gladstone Commercial Corp. and Gladstone Investment common stock, but may not engage in buying or selling contrary to the recommendation.

Hilliard Lyons has acted as a manager or co-manager of an offering of securities for Gladstone Commercial in the past 12-months.

Hilliard Lyons expects to receive investment banking compensation from Gladstone Commercial in the coming 3 months.

Investment Ratings

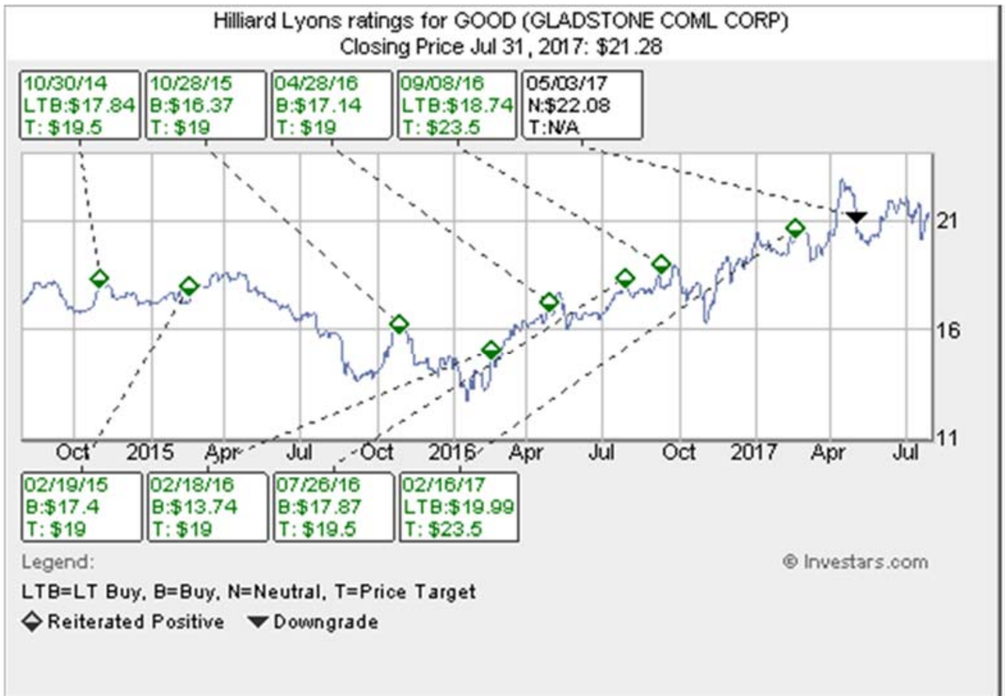
Buy - We believe the stock has significant total return potential in the coming 12 months.
Long-term Buy - We believe the stock is an above average holding in its sector, and expect solid returns to be realized over a longer time frame than our Buy rated issues, typically 2-3 years.
Neutral - We believe the stock is an average holding in its sector, is currently fully valued, and may be used as a source of funds if better opportunities arise.
Underperform - We believe the stock is vulnerable to a price set back in the next 12 months.

Suitability Ratings

1 - A large cap, core holding with a solid history
2 - A historically secure company which could be cyclical, has a shorter history than a "1" or is subject to event driven setbacks
3 - An above average risk/reward ratio could be due to small size, lack of product diversity, sporadic earnings or high leverage
4 - Speculative, due to small size, inconsistent profitability, erratic revenue, volatility, low trading volume or a narrow customer or product

	Hilliard Lyons Recommended Issues		Investment Banking Provided in Past 12 Mo.	
Rating	**# of Stocks Covered**	**% of Stocks Covered**	**Banking**	**No Banking**
Buy	36	29%	14%	86%
Hold/Neutral	79	63%	5%	95%
Sell	10	8%	0%	100%

As of 7 July 2017



Other Disclosures

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