



### COMPANY UPDATE/ESTIMATE CHANGE

#### Key Metrics

GOOD - NASDAQ - 10/31/17	\$21.66
2-3 Year Price Target	N/A
52-Week Range	\$16.02 - \$23.35
Shares Outstanding (mm)	28.0
Market Cap. (\$mm)	\$606.5
1-Mo. Average Daily Volume	36,512
Institutional Ownership	32.0%
Debt/Total Capital Sep-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	6.93%
Est. Fixed Charge Coverage	2.5X

#### FFO

	Prior		Prior		Current
	2016	2017E	2017E	2018E	2018E
1Q	\$0.39	--	\$0.38	A \$0.40	\$0.40
2Q	\$0.39	--	\$0.37	A \$0.42	\$0.42
3Q	\$0.39	--	\$0.38	A \$0.43	\$0.43
4Q	\$0.38	\$0.40	\$0.40	\$0.44	\$0.44
Year	\$1.55	\$1.54	\$1.53	\$1.69	\$1.69
P/E	14.0x		14.2x		12.8x

Note that quarters may not add due to rounding

#### Revenue (\$mm)

	Prior		Current	
	2016	2017E	2017E	2018E
1Q	\$21.5	--	\$22.3	A \$25.4
2Q	\$21.2	--	\$22.9	A \$26.0
3Q	\$21.6	--	\$24.4	A \$26.8
4Q	\$22.1	\$24.8	\$24.8	\$27.4
Year	\$86.4	\$94.1	\$94.4	\$105.6

**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.

## Gladstone Commercial Corp.

GOOD -- NASDAQ – Neutral-3

### Third Quarter Earnings

#### Investment Highlights

- Last night after the close, GOOD reported normalized Q3 FFO of \$0.38 a share, a penny below our estimate. The quarter was generally in line with our expectations although the share count was a little higher than we had anticipated as was property operating expense. We will be adjusting our current year FFO estimate to account for the penny miss versus our estimate. GOOD continues to make acquisitions, with two more completed during Q3.
- GOOD's share price has seen a pretty steady move up so far in 2017, pushing down its dividend yield, although it still has one of the higher yields in the REIT sector at just under 7%. While the company consistently paid the dividend through the recessionary environment and we have no reason to believe the company will not continue to pay the dividend, the yield is a little below our target yield for a purchase recommendation, with a payout ratio at the high end of the industry average.
- Our rating for GOOD remains Neutral. We believe that the current share price is reasonable in light of the risk profile of the company and that investors with longer investment horizons looking for solid levels of income and willing to take on some investment risk may wish to retain their positions in GOOD. Note that those who believe better opportunities exist elsewhere, may be surprised by higher capital gains tax obligations due to the recapture of the return of capital component that investors have benefited from while receiving that attractive dividend. We will have a report out with updated estimates and management commentary following the company's conference call this morning.

**Note Important Disclosures on Pages 6-7.**

**Note Analyst Certification on Page 6.**

**Third Quarter Review**

Total operating revenues were \$24.4 million, compared to \$21.6 million in Q3 '16, up 12.9% year over year (please see page 3). Rental revenue rose 12.3% to \$23.8 million. GOOD's tenant reimbursement income rose 43.2% to \$0.55 million, from \$0.38 million.

Property level operating expenses rose a more than expected 54.5% to \$2.18 million from \$1.41 million. Gladstone's fees are divided between base, administration and incentive fees. There was a 19.1% increase year-over-year in base management fees to \$1.28 million. In the 2017 third quarter, the incentive fee was \$0.64 million, compared to \$0.56 million in the previous year. G&A expenses were up 14.0% at \$0.65 million. We note that due to GOOD's outside management structure, G&A expense is typically small. Total operating expenses were up 28.3% year-over-year to \$5.04 million, excluding a \$1.79 million impairment charge in 2016.

EBITDA for Q3 was \$19.3 million compared to \$15.9 million in Q3 '16, a 21.8% increase, including the impairment charges, although excluding that there would have been a 9.4% rise. Interest expense fell 3.5% to \$6.1 million from \$6.3 million in the year earlier quarter. Net income available to common shareholders was a loss of \$0.4 million compared to a loss of \$2.3 million, and although this tends to be a somewhat useless number, due to its insignificant amount, it does show how little of GOOD's distribution is likely to be taxed to shareholders. In fact, typically 70-90% of the company's dividend has been a return of capital, which is a function of most of GOOD's cash flow generation being sheltered on a net income basis by depreciation and amortization expense, which are non-cash items. This provides investors with an even higher after tax return on investment. Preferred dividend and senior common stock payments rose 15.9% year-over-year as a result of issuances during the year. Core funds from operations, which exclude real estate gains, charges and due diligence expenses, were \$10.4 million in this year's third quarter versus \$9.4 million last year. FFO per share was \$0.38 versus \$0.39, on a 12.0% increase in shares outstanding.

The leverage on GOOD's balance sheet has moved down a bit since yearend with recent equity issuance more than offsetting debt added, and it now stands at approximately 1.49x, compared to 1.64x debt-to-equity (please see page 4) at yearend. Total debt rose to \$518.9 million from \$509.4 million at yearend. GOOD management has historically believed that the company could support leverage of 2.5x debt-to-equity, although in recent discussions, we believe they have lowered that threshold to less than two times.

**Other Q3 Activity**

**Investment Activity:** During the quarter, GOOD made two investments, purchasing one property, a 300,000 square foot single tenant industrial building in Philadelphia, PA for \$26.4 million that is leased to a single tenant with a Federal government guarantee through 2032, with a termination option beginning in 2027. The cash yield on the purchase is 6.41%, and the company entered into a \$14.9 million 10-year mortgage at a 3.75% fixed rate in conjunction with the purchase. The company also purchased a three property office building portfolio encompassing more than 300,000 square feet in the Orlando, FL market for a total of \$51.4 million, with an initial cash yield of 7.4%. The portfolio is 100%-leased, with the majority tenant being a major public company and a weighted average lease term of 8.7 years. The purchase was partially funded with a 3.89% fixed rate secured loan. GOOD also sold a vacant property during Q3 generating \$4.5 million in proceeds. The company also entered into a purchase and sale agreement after the quarter end, to sell a property in Texas to the tenant for \$5.6 million.

**Capital Markets Activity:** GOOD sold 1.2 million shares of common stock during the quarter, raising nearly \$23 million. The company will be using this capital to help in making the investments announced during Q3. The company also added 607,565 shares of common and 172,248 shares of preferred stock through its ATM share purchase program raising \$17.3 million. As noted above, the company also added some secured debt as part of the financing for the Q2 investments. Subsequent to quarter end the company amended its revolving credit and loan agreement, boosting it by \$50 million and lowering the interest rate by 25 basis points.

**Quarterly Income Statement**

	3rd Q 17	3rd Q 16	% Change
Rental Revenue	\$23,815,000	\$21,205,000	12.3%
Tenant Recovery Revenue	550,000	384,000	43.2%
Interest Income from Mortgage Note Receivable	0	0	
Total Operating Revenues	24,365,000	21,589,000	12.9%
Property Operating Expenses	2,178,000	1,410,000	54.5%
Base Management Fee	1,277,000	1,072,000	19.1%
Administration Fee	293,000	311,000	-5.8%
Incentive Fee	640,000	564,000	13.5%
Professional Fees	0	0	
Impairment Charge	0	0	
Shareholder Related Expenses	0	1,790,000	
Asset Retirement Obligation Expense	0	0	
Stock Option Compensation Expense	0	0	
Due Diligence expense	0	0	
Director Fees	0	0	
General and Administrative Expenses	650,000	570,000	14.0%
Total Operating Expenses	5,038,000	5,717,000	-11.9%
Credit to Incentive Fee	0	0	
EBITDA	19,327,000	15,872,000	21.8%
Interest Expense	6,119,000	6,338,000	-3.5%
Depreciation and Amortization Expenses	10,829,000	9,459,000	14.5%
Interest Income from Temporary Investments	0	0	
Interest Income - Employee Loans	0	0	
Other Income (expense)	0	0	
Discontinued Operations (loss)	4,000	(21,000)	
Net Income	\$2,383,000	\$54,000	4313.0%
Preferred, Senior Common Dividends	\$2,767,000	\$2,387,000	15.9%
Net Income Available to Common Shareholders	(\$384,000)	(\$2,333,000)	-83.5%
Net EPS (diluted)	(\$0.01)	(\$0.10)	-85.3%
Avg. Shares Outstanding (diluted)	27,234,569	24,309,170	12.0%
<b>Funds From Operations</b>			
	3rd Q 17	3rd Q 16	
Net Income Available to Common Shareholders	(\$384,000)	(\$2,333,000)	-83.5%
Depreciation and Amortization (incl. discontinued op	10,829,000	9,459,000	14.5%
Less Gain on Sale of Real Estate (net of taxes), other	(1,000)	2,247,000	
<b>Total Funds From Operations</b>	<b>\$10,444,000</b>	<b>\$9,373,000</b>	11.4%
<b>FFO Per Share</b>	<b>\$0.38</b>	<b>\$0.39</b>	-0.5%

Source: Company reports.

**Condensed Balance Sheet**

	September 30, 2017	December 31, 2016
<b>Real Estate (Net of Depreciation)</b>	<b>\$734,385,000</b>	<b>\$690,088,000</b>
<b>Mortgage Note Receivable</b>	<b>0</b>	<b>0</b>
Lease Intangibles (net)	115,210,000	105,553,000
Real estate assets & related held for sale	0	9,562,000
Cash and Cash Equivalents	4,287,000	4,658,000
Restricted Cash	3,533,000	3,030,000
Funds Held in Escrow	12,312,000	6,806,000
Interest Receivable - Mortgage Note	0	0
Interest Receivable - Officers	0	0
Deferred Rent Receivable	31,030,000	29,725,000
Deferred Financing Cost	0	0
Prepaid Expenses	0	0
Deposits on Real Estate	0	0
Other Assets	4,094,000	2,320,000
<b>Total Assets</b>	<b>\$904,851,000</b>	<b>\$851,742,000</b>
<b>Mortgage Note Payable</b>	<b>\$450,032,000</b>	<b>\$445,278,000</b>
<b>Borrowings under Line of Credit/Term loan</b>	<b>\$68,845,000</b>	<b>\$64,117,000</b>
Deferred Rent Liability	15,554,000	12,647,000
Asset Retirement Obligation Liability	3,136,000	3,406,000
Accounts Payable and Accrued Expenses	8,221,000	5,891,000
Due to Adviser	2,250,000	2,075,000
Other Liabilities related to assets for sale	0	1,041,000
Rent Received / Security Deposits / Other	7,803,000	6,667,000
<b>Total Liabilities</b>	<b>555,841,000</b>	<b>541,122,000</b>
Preferrd, Senior common Stock	81,981,000	70,746,000
Common Stock	28,000	25,000
Additional Paid in Capital	520,143,000	463,436,000
Other	172,000	0
Distribution in Excess of Accumulated Earnings	(253,314,000)	(223,587,000)
<b>Total Shareholders' Equity</b>	<b>\$349,010,000</b>	<b>\$310,620,000</b>
<b>Total Liabilities and Shareholders' Equity</b>	<b>\$904,851,000</b>	<b>\$851,742,000</b>

<b>Balance Sheet Ratio Analysis</b>	September 30, 2017	December 31, 2016
Investments (net) as % of Assets	81.2%	81.0%
Cash & Equiv. and Restricted Cash as % of Assets	0.9%	0.9%
Debt to Equity	148.7%	164.0%
Total Liabilities as % of Assets	61.4%	63.5%
Shareholders' Equity as % of Assets	38.6%	36.5%

Source: Company reports.

**First Take**

GOOD's numbers were largely in line with our expectations, with the higher share count and increased property operating expense the major differences. We will be asking management about the higher property operating expense level on the conference call. The level of acquisition activity was somewhat higher than our near term expectations. Revenues were slightly above our expectations, while interest expense was a little lower with the continued work down in rates. Overall, operations were pretty much what we anticipated. Management noted that it had signed several new leases during the quarter, as well as leasing another property that was vacant. Management continues to recycle properties by selling non-core properties and using the capital to purchase properties more fitting the company's strategy. The company added the investments discussed previously to its portfolio and we note that the company has only 3.9% of forecasted lease revenue expiring through 2019. At this point our Neutral rating is retained, with the company's shares remaining above our targeted price for purchase, but offering attractive yield characteristics.

**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 Commercial**

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 \$605 million, is one of the smallest 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 - \$10.09); rated Neutral by Hilliard Lyons), Gladstone Commercial Corporation, Gladstone Land Corp. (LAND, \$13.23; rated Long-term Buy by Hilliard Lyons) and Gladstone Capital Corporation (GLAD - \$9.74; 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 Investment and Gladstone Commercial common stock, but may not engage in buying or selling contrary to the recommendation.

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

Hilliard Lyons has received investment banking compensation from Gladstone Commercial in the past 12-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

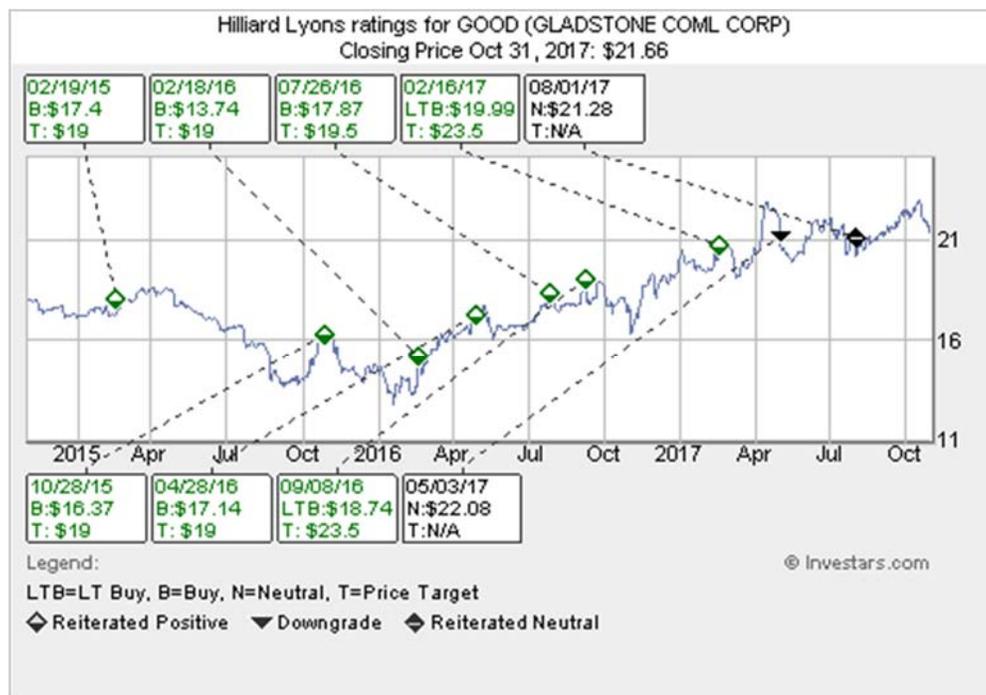
2 - A historically secure company which could be cyclical, has a shorter history than a "1" or is subject to event driven setbacks

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

Rating	Hilliard Lyons Recommended Issues		Investment Banking Provided in Past 12 Mo.	
	# of Stocks Covered	% of Stocks Covered	Banking	No Banking
Buy	39	32%	8%	92%
Hold/Neutral	74	60%	9%	91%
Sell	8	7%	0%	100%
Restriction	2	2%	100%	0%

As of 5 October 2017



### Other Disclosures

Opinions expressed are subject to change without notice and do not take into account the particular investment objectives, financial situation or needs of individual investors. Employees of J.J.B. Hilliard, W.L. Lyons, LLC or its affiliates may, at times, release written or oral commentary, technical analysis or trading strategies that differ from the opinions expressed here.

J.J.B. Hilliard, W.L. Lyons, LLC is a multi-disciplined financial services firm that regularly seeks investment banking assignments and compensation from issuers for services including, but not limited to, acting as an underwriter in an offering or financial advisor in a merger or acquisition, or serving as placement agent in private transactions.

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