



Gladstone Commercial Corporation (GOOD)

Updated July 15th, 2019 by Josh Arnold

Key Metrics

Current Price:	\$21	5 Year CAGR Estimate:	2.6%	Volatility Percentile:	33.8%
Fair Value Price:	\$17	5 Year Growth Estimate:	0.0%	Momentum Percentile:	62.2%
% Fair Value:	125%	5 Year Valuation Multiple Estimate:	-4.4%	Growth Percentile:	2.0%
Dividend Yield:	7.0%	5 Year Price Target	\$17	Valuation Percentile:	24.5%
Dividend Risk Score:	B	Retirement Suitability Score:	A	Total Return Percentile:	14.3%

Overview & Current Events

Gladstone Commercial Corporation is a real estate investment trust, or REIT, that specializes in single-tenant and anchored multi-tenant net leased industrial and office properties across the US. The trust targets primary and secondary markets that possess favorable economic growth trends, growing populations, strong employment, and robust growth trends. The trust's stated goal is pay shareholders monthly distributions, which it has done for more than 10 consecutive years. Gladstone owns 102 properties in 24 states that are leased to 97 unique tenants.

Gladstone reported Q1 earnings on 4/30/19 and results were largely in line with expectations. Total operating revenue rose 3.2% year-over-year while operating expenses were up 2.6%. Funds-from-operations, or FFO, increased 3.6% on a dollar basis, but core FFO came in flat at \$0.39 due to a higher share count. Revenue and FFO-per-share increased due to stronger rental income.

The trust's portfolio was essentially the same size year-over-year as Gladstone has one extra property, but leased square feet was flat year-over-year at 11.4 million. The trust acquired two fully-leased properties while divesting another one during the quarter as it continues to optimize its portfolio's yield. Gladstone's impressive occupancy rate remained very high at 98.9%, although that is down fractionally from 99.1% in the year-ago period.

After an in-line Q1 report, our initial estimate for FFO-per-share for this year is \$1.55. This is consistent with last year and years prior as Gladstone's investments tend to offset the rising share count.

Growth on a Per-Share Basis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2024
FFO	\$1.58	\$1.64	\$1.53	\$1.48	\$1.49	\$1.80	\$1.54	\$1.53	\$1.54	\$1.58	\$1.55	\$1.55
DPS	\$1.50	\$1.50	\$1.50	\$1.50	\$1.50	\$1.50	\$1.50	\$1.50	\$1.50	\$1.50	\$1.50	\$1.50
Shares	8.6	8.7	10.9	11.1	15.7	17.3	21.2	23.2	26.4	28.8	33.0	42.0

Gladstone reports funds-from-operations, or FFO, per share rather than earnings-per-share or another similar metric. This is consistent with other REITs and we'll use FFO as the preferred proxy for earnings.

Gladstone's FFO-per-share has been between \$1.50 and \$1.60 for most of the past decade as the trust continues to issue new shares and debt to fund acquisitions, but those acquisitions fail to provide an economic gain. In other words, while the trust's new properties provide growth on a dollar basis, when the cost of those acquisitions is factored in, it is essentially no gain on a per-share basis. We don't have any reason to believe this will change moving forward as Gladstone's common shares are quite expensive to issue, yielding 7% to 9% at most times, and as its preferred stock and debt aren't any cheaper. This means that Gladstone will struggle to produce economic gains with its capital issuances given that the yields on its properties are also in the high single digits.

As a result, our long-term growth estimate for Gladstone is 0%. We don't see any cause for pessimism as earnings impairment isn't likely. However, investors should note that any sort of meaningful growth is going to be very difficult to come by.

The distribution has also been flat at \$1.50 for the past ten years as the trust has struggled to grow FFO-per-share and thus, has been unable to boost the distribution.

Disclosure: This analyst has no position in the security discussed in this research report, and no plans to initiate one in the next 72 hours.



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Valuation Analysis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Now	2024
Avg. P/E	7.5	10.0	11.4	11.9	12.6	9.8	10.7	11.1	13.8	11.9	13.8	11.0
Avg. Yld.	12.7%	9.2%	8.6%	8.5%	8.0%	8.5%	9.1%	8.8%	7.1%	8.0%	7.0%	8.8%

The trust trades today for 13.8, which is equal to the highest valuation it has traded for in the past decade. As such, we believe shares are meaningfully overvalued. The long-term average valuation for Gladstone is just over 11 times FFO-per-share, which is where we assess fair value. Should shares revert to 11 times FFO-per-share, investors would see a 4.4% headwind to total annual returns.

This is true with the yield as well as the current 7% yield is the lowest the stock has seen in the past decade. We see the yield rising to 8.8% over time as the distribution stays flat, and as the share price moves lower.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2024
Payout	95%	91%	98%	101%	101%	83%	97%	98%	97%	95%	97%	97%

Gladstone doesn't necessarily have a competitive advantage given that it operates in much the same way as any other commercial REIT. However, Gladstone's selection of properties has been outstanding over time as its occupancy has never dipped below 96%.

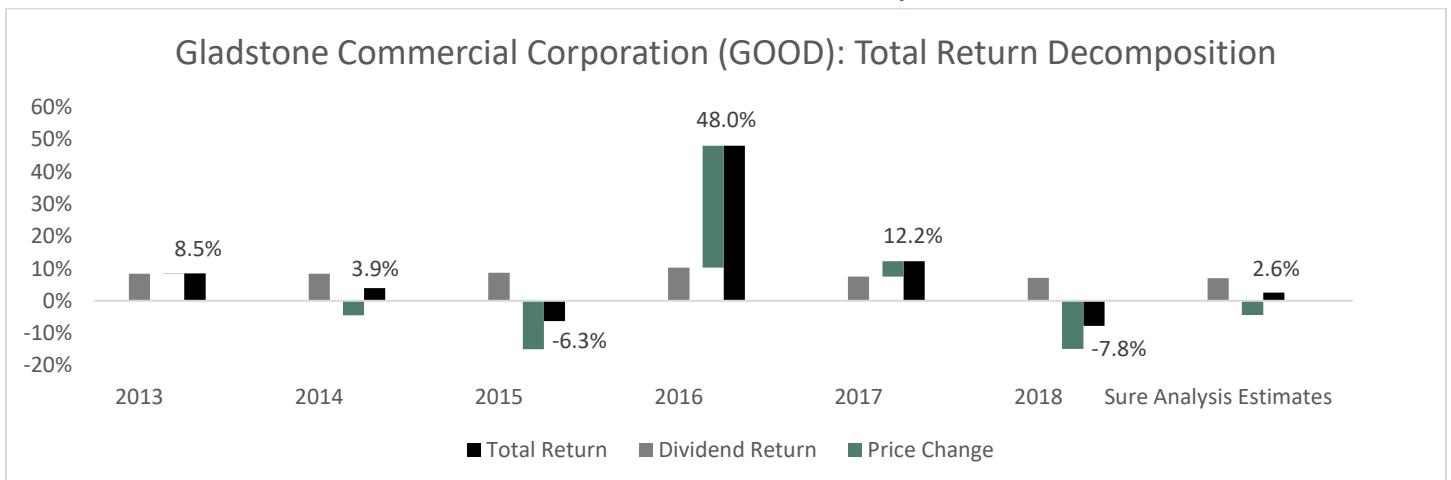
In the case of recession, Gladstone should fare quite well as more than half of its properties are leased through 2024, so the impact on the trust's earnings should be minimal. Indeed, this is consistent with how Gladstone performed during the Great Recession.

The payout ratio is very high but we see the trust's steady FFO-per-share of more than \$1.50 annually as enough to maintain the current dividend. Investors should not expect a raise anytime soon due to factors discussed above.

Final Thoughts & Recommendation

We see just 2.6% total annual returns for Gladstone Commercial due to the high valuation of the stock. We see the 7% yield as attractive but given this is a decade-low yield, we think investors will get a better chance to own the stock at a lower price and higher yield. We like Gladstone's recession performance and its steady FFO-per-share, but there is no growth to speak of. We rate Gladstone a sell given the overvaluation, and despite the high yield.

Total Return Breakdown by Year



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Income Statement Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Revenue	43	42	44	51	61	74	84	86	95	107
Gross Profit	42	41	43	50	58	69	78	80	87	95
Gross Margin	97.9%	97.7%	97.8%	96.9%	94.5%	93.6%	93.7%	93.2%	91.9%	89.3%
SG&A Exp.	7	9	5	6	6	8	10	10	11	12
D&A Exp.	13	13	14	17	23	29	35	38	43	48
Operating Profit	22	19	23	27	29	32	33	33	33	36
Operating Margin	51.8%	44.2%	53.2%	53.3%	47.7%	43.4%	39.9%	38.0%	35.1%	33.4%
Net Profit	5	5	6	4	2	-6	4	4	6	12
Net Margin	10.8%	11.8%	13.0%	7.3%	2.5%	-8.0%	4.3%	4.6%	6.3%	11.5%
Free Cash Flow	15	18	20	23	20	28	31	41	47	56

Balance Sheet Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Total Assets	417	411	453	565	691	788	827	852	928	939
Cash & Equivalents	3	7	3	6	9	9	5	5	7	7
Goodwill & Int. Ass.	28	27	38	57	80	99	105	106	119	111
Total Liabilities	298	299	318	442	507	570	593	612	662	684
Accounts Payable			2	5	2	8	6	6	7	3
Long-Term Debt	286	288	304	384	447	503	530	515	547	570
Shareholder's Equity	118	111	135	122	183	218	234	240	267	250
D/E Ratio	2.41	2.58	2.25	3.14	2.44	2.31	2.27	2.14	2.05	2.28

Profitability & Per Share Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Return on Assets	1.1%	1.2%	1.3%	0.7%	0.2%	-0.8%	0.4%	0.5%	0.7%	1.3%
Return on Equity	3.7%	4.3%	4.6%	2.9%	1.0%	-2.9%	1.6%	1.7%	2.3%	4.8%
ROIC	1.1%	1.2%	1.4%	0.8%	0.3%	-0.9%	0.5%	0.5%	0.8%	1.5%
Shares Out.	8.6	8.7	10.9	11.1	15.7	17.3	21.2	23.2	26.4	28.8
Revenue/Share	4.98	4.87	4.27	4.64	4.56	4.15	3.79	3.58	3.47	3.61
FCF/Share	1.80	2.11	1.91	2.12	1.48	1.59	1.42	1.70	1.72	1.88

Note: All figures in millions of U.S. Dollars unless per share or indicated otherwise.

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