



Gladstone Commercial Corporation (GOOD)

Updated May 15th, 2020 by Josh Arnold

Key Metrics

Current Price:	\$15	5 Year CAGR Estimate:	9.6%	Market Cap:	\$490M
Fair Value Price:	\$16	5 Year Growth Estimate:	0.0%	Ex-Dividend Date:	05/18/20
% Fair Value:	94%	5 Year Valuation Multiple Estimate:	1.2%	Dividend Payment Date:	05/29/20
Dividend Yield:	10.3%	5 Year Price Target	\$16	Years Of Dividend Growth:	0
Dividend Risk Score:	F	Retirement Suitability Score:	C	Last Dividend Increase:	N/A

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 to pay shareholders monthly distributions, which it has done for more than 10 consecutive years. Gladstone owns over 100 properties in 24 states that are leased to nearly 100 unique tenants, and has a market capitalization of \$490 million.

Gladstone reported first quarter earnings on April 28th, with results coming in ahead of expectations. Core funds-from-operations per share came to 40 cents, ahead of expectations for 39 cents, as the COVID-19-related shutdowns across the US had very little impact on Gladstone's operating performance. Core FFO was up due to an increase in rental income from Q4 2019 acquisitions, which were partially offset by an increase in interest expense.

Operating revenue was \$33.6 million, up 14% quarter-over-quarter thanks to these acquisitions. Operating expenses were up just 7.3% to \$24.1 million.

The trust said it would sell non-core assets and redeploy the proceeds into stronger targets with better growth prospects, taking advantage of economic dislocation caused by the virus. Gladstone also said it collected 98% of April cash base rent, highlighting that it is holding up very well during this crisis. Portfolio occupancy remains at 97%.

We've cut a nickel from our FFO-per-share estimate for this year, and we now see \$1.55. Gladstone is clearly holding up during this crisis, but commentary from management suggests there is at least some pain ahead due to rent deferrals.

Growth on a Per-Share Basis

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2025
FFO	\$1.64	\$1.53	\$1.48	\$1.49	\$1.80	\$1.54	\$1.53	\$1.54	\$1.58	\$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
Shares¹	8.7	10.9	11.1	15.7	17.3	21.2	23.2	26.4	28.8	33.0	35.0	44.0

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 underlying earnings power.

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 its preferred stock and debt are not significantly 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

¹ Share count in millions

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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 difficult to generate.

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.

Valuation Analysis

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	Now	2025
Avg. P/E	10.0	11.4	11.9	12.6	9.8	10.7	11.1	13.8	11.9	13.7	9.4	10.0
Avg. Yld.	9.2%	8.6%	8.5%	8.0%	8.5%	9.1%	8.8%	7.1%	8.0%	7.0%	10.3%	9.7%

Today the trust trades for just 9.4 times this year's FFO-per-share estimate, which is down from a decade-high valuation in late 2019. As such, the valuation has improved, and shares are now quite attractively priced. The long-term average valuation for Gladstone is just over 11 times FFO-per-share, and we've moved fair value down to 10 times FFO in order to account for COVID-19. This implies a small tailwind from the valuation in the coming years.

The current 10.3% yield is near the highest the stock has seen in the past decade. We see the yield falling to 9.7% over time as the distribution stays flat, and as the valuation potentially moves a bit higher.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2026
Payout	91%	98%	101%	101%	83%	97%	98%	97%	95%	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%.

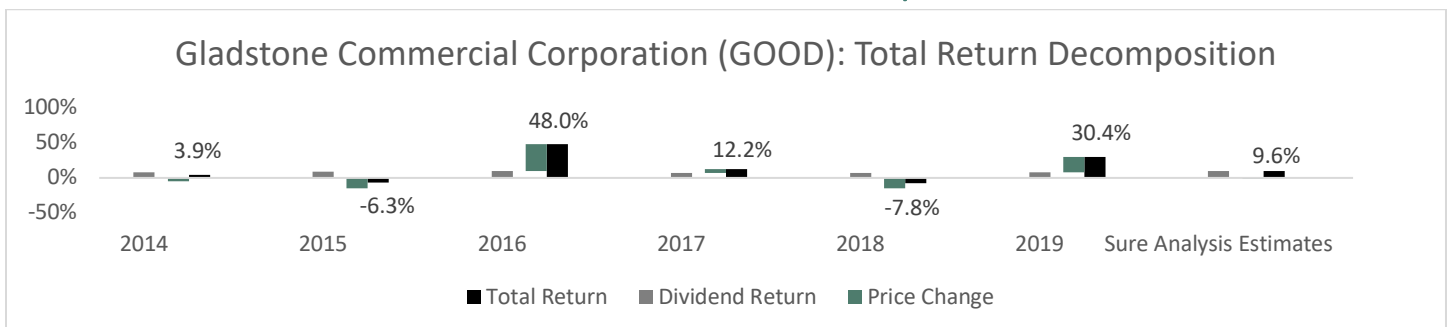
In the case of recession, Gladstone should fare quite well as more than half of its properties are leased through 2024, so the impact on the trust's earnings should be minimal. Indeed, this is consistent with how Gladstone performed during the Great Recession.

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 the factors discussed above.

Final Thoughts & Recommendation

We see 9.6% total annual returns for Gladstone Commercial, even accounting for lower FFO and fair value estimates. We see the 10.3% yield as attractive and now that the valuation is lower, we think Gladstone has a lot to offer. We like Gladstone's recession performance and its steady FFO-per-share, but there is little growth. We're upgrading Gladstone from sell to hold on much-improved total return prospects.

Total Return Breakdown by Year



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Income Statement Metrics

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Revenue	42	44	51	61	74	84	86	95	107	114
Gross Profit	41	43	50	58	69	78	80	87	95	102
Gross Margin	97.7%	97.8%	96.9%	94.5%	93.6%	93.7%	93.2%	91.9%	89.3%	89.0%
SG&A Exp.	9	5	6	6	8	10	10	11	12	14
D&A Exp.	13	14	17	23	29	35	38	43	48	52
Operating Profit	19	23	27	29	32	33	33	33	36	36
Operating Margin	44.2%	53.2%	53.3%	47.7%	43.4%	39.9%	38.0%	35.1%	33.4%	31.4%
Net Profit	5	6	4	2	-6	4	4	6	12	10
Net Margin	11.8%	13.0%	7.3%	2.5%	-8.0%	4.3%	4.6%	6.3%	11.5%	8.4%
Free Cash Flow	18	20	23	20	28	31	41	47	56	60

Balance Sheet Metrics

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Total Assets	411	453	565	691	788	827	852	928	939	1040
Cash & Equivalents	7	3	6	9	9	5	5	7	7	7
Goodwill & Int. Ass.	27	38	57	80	99	105	106	119	111	115
Total Liabilities	299	318	442	507	570	593	612	662	684	828
Accounts Payable		2	5	2	8	6	6	7	3	6
Long-Term Debt	288	304	384	447	503	530	515	547	570	627
Shareholder's Equity	111	135	122	183	218	234	240	267	250	208
D/E Ratio	2.58	2.25	3.14	2.44	2.31	2.27	2.14	2.05	2.28	3.01

Profitability & Per Share Metrics

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Return on Assets	1.2%	1.3%	0.7%	0.2%	-0.8%	0.4%	0.5%	0.7%	1.3%	1.0%
Return on Equity	4.3%	4.6%	2.9%	1.0%	-2.9%	1.6%	1.7%	2.3%	4.8%	4.2%
ROIC	1.2%	1.4%	0.8%	0.3%	-0.9%	0.5%	0.5%	0.8%	1.5%	1.2%
Shares Out.	8.7	10.9	11.1	15.7	17.3	21.2	23.2	26.4	28.8	33.0
Revenue/Share	4.87	4.27	4.64	4.56	4.15	3.79	3.58	3.47	3.61	3.73
FCF/Share	2.11	1.91	2.12	1.48	1.59	1.42	1.70	1.72	1.88	1.96

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

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