



Gladstone Commercial Corporation (GOOD)

Updated May 13th, 2023, by Josh Arnold

Key Metrics

Current Price:	\$11	5 Year CAGR Estimate:	13.8%	Market Cap:	\$451 M
Fair Value Price:	\$15	5 Year Growth Estimate:	1.0%	Ex-Dividend Date:	05/16/23
% Fair Value:	77%	5 Year Valuation Multiple Estimate:	5.5%	Dividend Payment Date:	05/31/23
Dividend Yield:	10.7%	5 Year Price Target	\$15	Years Of Dividend Growth:	0
Dividend Risk Score:	F	Retirement Suitability Score:	C	Rating:	Buy

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 U.S. 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 17 consecutive years. Gladstone owns over 100 properties in 24 states that are leased to about 100 unique tenants and has a market capitalization of \$451 million.

Gladstone posted first quarter earnings on May 3rd, 2023, and results were slightly weaker than expected. The REIT posted funds-from-operations of 37 cents per share, which met estimates. Revenue was \$36.6 million, up 2.9% year-over-year, but missed estimates by about \$1 million.

The trust noted core FFO was \$15 million, up 9.3% from the December quarter, which was due to the incentive fee being contractually eliminated for the March quarter, partially offset by a decline in lease revenue from higher vacancy rates.

Collection of April cash rent was 100%. The trust issued \$0.3 million of preferred stock, and repaid debt of \$2.7 million that carried a fixed interest rate of 4.16%.

Gladstone acquired 76 thousand square feet of industrial property for \$5.3 million at a cap rate of 9.7%, leased to a single tenant for 20 years. In addition, the trust renewed or newly leased 361 thousand square feet with remaining lease terms of 5.5 years to 14 years.

We have slightly reduced our estimate of FFO-per-share for this year to \$1.40 following a slightly weak start to the year.

Growth on a Per-Share Basis

Year	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2028
FFO	\$1.49	\$1.80	\$1.54	\$1.53	\$1.54	\$1.58	\$1.58	\$1.57	\$1.54	\$1.56	\$1.40	\$1.47
DPS	\$1.50	\$1.50	\$1.50	\$1.50	\$1.50	\$1.50	\$1.50	\$1.50	\$1.50	\$1.50	\$1.20	\$1.20
Shares¹	15.7	17.3	21.2	23.2	26.4	28.8	33.0	35.3	37.8	40.0	43.0	52.0

Gladstone reports funds-from-operations, or FFO, per share rather than earnings-per-share. 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 1%. 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 had been flat at \$1.50 for the past decade as the trust has struggled to grow FFO-per-share and thus, has been unable to boost the distribution. For the start of 2023, Gladstone cut its distribution by 20% to a new level of \$1.20 per year.

Valuation Analysis

Year	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	Now	2028
Avg. P/E	12.6	9.8	10.7	11.1	13.8	11.9	13.7	11.4	13.9	11.9	8.0	10.5
Avg. Yld.	8.0%	8.5%	9.1%	8.8%	7.1%	8.0%	7.0%	8.4%	7.0%	8.1%	10.7%	7.8%

Today the trust trades for 8 times this year's FFO-per-share estimate, which is very low against historical norms. The long-term average valuation for Gladstone is just over 11 times FFO-per-share, and we've moved our fair value estimate down slightly to 10.5 times earnings. This implies a tailwind from the valuation in the coming years.

The current 10.7% yield is largely in line with historical yields. We see the yield potentially declining should the valuation rise to meet our fair value estimate.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2028
Payout	101%	83%	97%	98%	97%	95%	95%	96%	97%	96%	86%	82%

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 remained high through a variety of economic conditions.

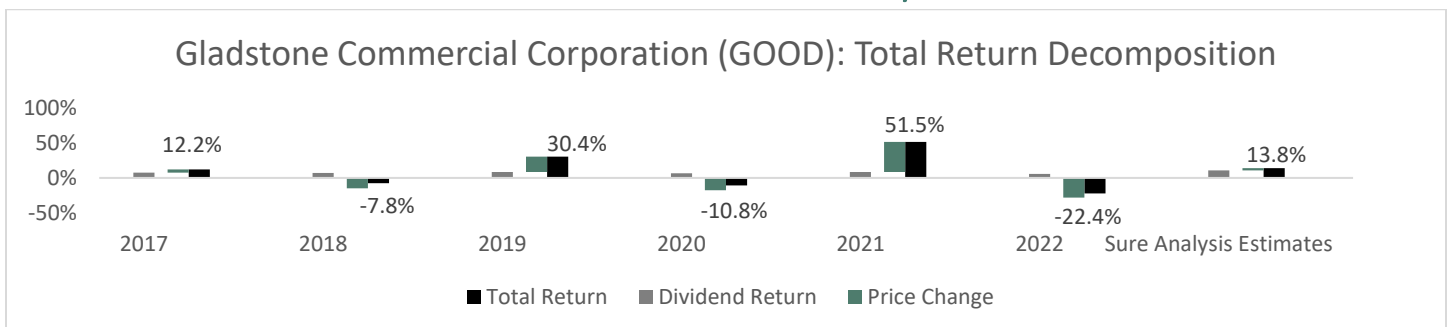
In the case of recession, Gladstone should fare quite well as more than half of its properties are leased through 2024, so the impact on the trust's earnings should be minimal, which is consistent with how Gladstone performed during the Great Recession. Last year's challenges have shown that Gladstone can weather a tough environment.

The payout ratio is very high, but we see the trust's FFO-per-share of \$1.40+ annually as enough to maintain the lowered dividend. Investors should not expect a meaningful raise anytime soon due to the factors discussed above.

Final Thoughts & Recommendation

We forecast 13.8% total annual returns for Gladstone Commercial moving forward. We see the yield as attractive at 10.7%, and the stock is below fair value, with a resulting 5.5% tailwind. We like Gladstone's recession performance and its steady FFO-per-share, but there is little growth (~1%). We're upgrading the stock from hold to buy on higher total return potential.

Total Return Breakdown by Year



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Income Statement Metrics

Year	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Revenue	61	74	84	86	95	107	114	133	138	149
Gross Profit	58	69	78	80	87	95	102	107	111	122
Gross Margin	94.5%	93.6%	93.7%	93.2%	91.9%	89.3%	89.0%	80.5%	80.3%	81.9%
SG&A Exp.	6	8	10	10	11	12	14	15	15	17
D&A Exp.	23	29	35	38	43	48	52	55	60	62
Operating Profit	29	32	33	33	33	36	36	37	35	43
Operating Margin	47.7%	43.4%	39.9%	38.0%	35.1%	33.4%	31.4%	27.7%	25.3%	28.9%
Net Profit	2	(6)	4	4	6	12	10	15	10	9
Net Margin	2.5%	-8.0%	4.3%	4.6%	6.3%	11.5%	8.4%	11.2%	7.1%	6.0%
Free Cash Flow	20	28	31	41	47	56	60	65	70	69

Balance Sheet Metrics

Year	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Total Assets	691	788	827	852	928	939	1,040	1,098	1,143	1,202
Cash & Equivalents	9	9	5	5	7	7	7	11	8	12
Goodwill & Int. Ass.	80	99	105	106	119	111	115	117	114	112
Total Liabilities	507	570	593	612	662	684	828	882	941	997
Accounts Payable	2	8	6	6	7	3	6	4	7	10
Long-Term Debt	447	503	525	509	543	566	627	669	708	749
Shareholder's Equity	183	218	234	240	267	250	208	213	201	203
LTD/E Ratio	2.44	2.31	2.25	2.12	2.03	2.27	3.01	3.14	3.51	3.69

Profitability & Per Share Metrics

Year	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Return on Assets	0.2%	-0.8%	0.4%	0.5%	0.7%	1.3%	1.0%	1.4%	0.9%	0.8%
Return on Equity	1.0%	-2.9%	1.6%	1.7%	2.3%	4.8%	4.2%	7.1%	4.7%	4.6%
ROIC	0.3%	-0.9%	0.5%	0.5%	0.8%	1.5%	1.2%	1.7%	1.1%	1.0%
Shares Out.	15.7	17.3	21.2	23.2	26.4	28.8	33.0	35.3	37.8	39.0
Revenue/Share	4.56	4.15	3.79	3.58	3.60	3.72	3.73	3.91	3.77	3.82
FCF/Share	1.48	1.59	1.42	1.70	1.78	1.94	1.96	1.92	1.92	1.78

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

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