



# GLADSTONE COMMERCIAL

2006 ANNUAL REPORT

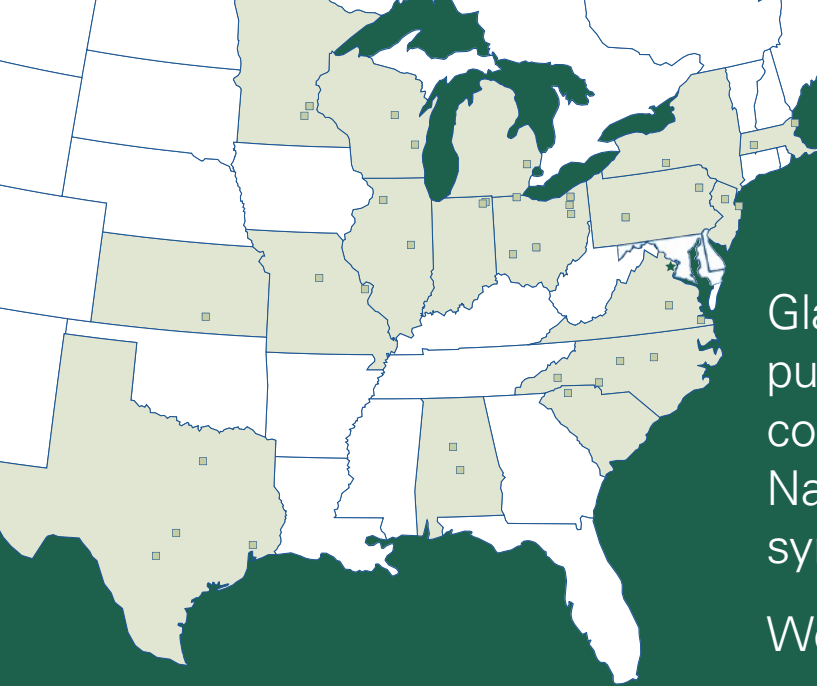




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Gladstone Commercial is a public real estate investment company traded on the Nasdaq under the trading symbol: GOOD

We Pay Monthly Dividends



**GLADSTONE COMMERCIAL CORPORATION** is a real estate investment trust, or REIT, that seeks to invest in and own net leased industrial and commercial real property and selectively make long-term industrial and commercial mortgage loans. As of December 31, 2006, we owned 38 properties totaling 4,629,552 square feet located in 17 states. These properties consist primarily of office, warehouse, industrial, commercial and manufacturing facilities.

Our principal investment objectives are to generate cash flow for monthly distributions to our stockholders and to increase the value of our common stock. Our primary strategy to achieve our investment objectives is to invest in and own a diversified portfolio of leased industrial and commercial real estate that we believe will produce stable cash flow and increase in value over time. We expect to sell some of our real estate assets from time to time when our Adviser determines that doing so would be advantageous to us and our stockholders. We also expect to occasionally make mortgage loans secured by income-producing commercial or industrial real estate, which loans may have some form of equity participation.

**WE CURRENTLY OWN THREE TYPES OF COMMERCIAL AND INDUSTRIAL REAL ESTATE PROPERTIES:**

- 1. Real estate leased to tenants with small and medium-sized unrated businesses as well as larger rated businesses in some instances. Our target market companies are normally too small to have ratings similar to larger public companies.*
- 2. Real estate occupied by companies controlled by buyout funds. We are very familiar with the leveraged buyout business and are comfortable owning these business real estate properties occupied by such tenants.*
- 3. Real estate purchased from and leased back to businesses that are seeking to raise capital from the sale of their real estate to invest proceeds into their operations.*

We are managed by Gladstone Management Corporation, our Adviser, whose principal offices are located at 1521 Westbranch Drive, McLean, Virginia 22102, a suburb of Washington, DC. Our Adviser also has offices in New York, New York; Pittsburgh, Pennsylvania; Chicago, Illinois; Morristown, New Jersey; Lexington, Kentucky; and Dallas, Texas.

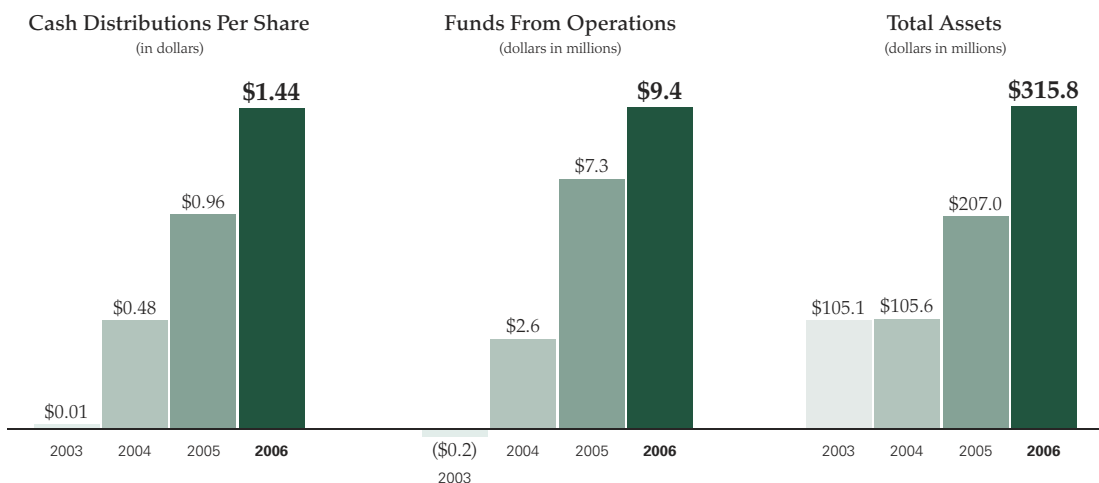
*Cover Photo: Aerial view of the White House and the Washington Monument.*

# Financial Highlights

	Year ended December 31, 2006	Year ended December 31, 2005	Year ended December 31, 2004	Period February 14, 2003 (inception) through December 31, 2003
<b>Operating Data:</b>				
Total operating revenue	\$ 25,945,546	\$ 12,881,506	\$ 4,191,329	\$ 12,180
Total operating expenses	(14,067,096)	(7,185,040)	(3,276,735)	(557,148)
Other income (expense)	(8,521,419)	(2,185,509)	614,659	304,097
Income (loss) from continuing operations	3,357,031	3,510,957	1,529,253	(240,871)
Discontinued operations	1,015,797	90,988	94,675	—
Net income (loss)	\$ 4,372,828	\$ 3,601,945	\$ 1,623,928	\$ (240,871)
Dividends attributable to preferred stock	(2,186,890)	—	—	—
Net income (loss) available to common stockholders	\$ 2,185,938	\$ 3,601,945	\$ 1,623,928	\$ (240,871)
<b>Share and Per Share Data:</b>				
Earnings per weighted average common share—basic				
Income from continuing operations (net of dividends attributable to preferred stock)	\$ 0.15	\$ 0.46	\$ 0.20	\$ (0.07)
Discontinued operations	0.13	0.01	0.01	—
Net income available to common stockholders	\$ 0.28	\$ 0.47	\$ 0.21	\$ (0.07)
Earnings per weighted average common share—diluted				
Income from continuing operations (net of dividends attributable to preferred stock)	\$ 0.14	\$ 0.46	\$ 0.20	\$ (0.07)
Discontinued operations	0.13	0.01	0.01	—
Net income available to common stockholders	\$ 0.27	\$ 0.47	\$ 0.21	\$ (0.07)
Weighted average shares outstanding—basic	7,827,781	7,670,219	7,649,855	3,229,119
Weighted average shares outstanding—diluted	7,986,690	7,723,220	7,708,534	3,229,119
Cash dividends declared per common share	\$ 1.44	\$ 0.96	\$ 0.48	\$ 0.01
<b>Supplemental Data:</b>				
Net income (loss) available to common stockholders	\$ 2,185,938	\$ 3,601,945	\$ 1,623,928	\$ (240,871)
Real estate depreciation and amortization, including discontinued operations	8,349,474	3,651,119	973,345	5,827
Less: Gain on sale of real estate, net of taxes paid	(1,106,590)	—	—	—
Funds from operations available to common stockholders <sup>(1)</sup>	\$ 9,428,822	\$ 7,253,064	\$ 2,597,273	\$ (235,044)
Ratio of earnings to combined fixed charges and preferred dividends <sup>(2)</sup>	1.4x	2.4x	64.5x	—
<b>Balance Sheet Data:</b>				
Real estate, before accumulated depreciation	\$243,713,542	\$165,043,639	\$ 61,251,455	\$ 5,440,772
Total assets	\$315,766,022	\$207,046,954	\$105,585,094	\$105,061,370
Mortgage notes payable and borrowings under the line of credit	\$154,494,438	\$105,118,961	\$ —	\$ —
Total stockholders' equity	\$152,224,176	\$ 98,948,536	\$102,692,693	\$104,750,655
Total common shares outstanding	8,565,264	7,672,000	7,667,000	7,642,000

(1) Funds from operations in a non-GAAP financial measure for a reconciliation of funds from operations to net income, see page 59 of the enclosed Annual Report on Form 10-K for the year ended December 31, 2006.

(2) "Earnings" consist of net income (loss) from continuing operations before fixed charges. "Fixed charges" consist of interest expense, amortization of deferred financing fees and the portion of operating lease expense that represents interest.



## To Our Stockholders:



We had a good year in 2006. We increased the number of properties we own, improved financial results and have positioned the company to have a successful year in 2007.

### **GROWING IN 2006**

Our 2006 year-end performance reflects our focus on single tenant properties and our rigorous underwriting. Among our 2006 results were:

- An increase in Funds from Operations (“FFO”) to \$9.4 million, or \$1.18 per diluted common share, an increase of 26% per share over 2005;
- An approximately \$1.1 million gain, after taxes, on the sale of two properties;
- Acquisition of one building in satisfaction of our mortgage loan on the Sterling Heights, Michigan property for a fair market value of \$11.3 million; and
- Acquisition of nine other properties, for a total investment of \$78.5 million in new property investments, growing our portfolio to 38 properties with a total asset value of over \$300 million.

Our growth has enabled our monthly dividend to increase to a per-share rate of \$0.12, or \$1.44 per year. Our goal is to keep raising our monthly dividend, and we will work hard to make that happen. We are proud that we can share our growth with our stockholders and we hope to post even better results in 2007.

For the year ended December 31, 2006, we acquired \$78.5 million in new properties, and acquired a building (that is fully leased) in satisfaction of an outstanding mortgage loan for a fair market value of \$11.3 million. During the year we raised \$53.8 million in additional equity, with net proceeds to us of \$51.1 million after expenses, in the form of preferred stock, thereby avoiding dilution of our common stockholders. We now have two outstanding series of preferred stock: a 7.75% Series A Preferred Stock (NASDAQ: GOODP) that pays a monthly dividend of \$0.161 per share and a 7.50% Series B Preferred Stock (NASDAQ: GOODO) that pays a monthly dividend of \$0.156 per share.

Pictured above from left to right are Terry Brubaker, David Gladstone, and George “Chip” Stelljes III.

We continue to generate additional investment funds from mortgage financings on our properties, and as of year end we were approximately 1:1 leveraged. We consider this to be very conservative. With the closing of our new line of credit in December 2006, led by KeyBank National Association, we are able to increase our available leverage. This line of credit and the proceeds from our mortgage financings have positioned us to grow during 2007.

#### **LOOKING AHEAD**

Subsequent to year end, we acquired two properties for a total investment of \$15.7 million. We are confident that we will continue to build our portfolio during 2007 by acquiring additional properties, despite challenging conditions. Even though we have experienced rising interest rates, increasing energy prices and slowing housing and mortgage markets, our industrial and commercial real estate markets have not subsided. As a result we continue to be very careful with each of our property acquisitions because prices are still very high.

The majority of triple-net property buyers working in major markets seek tenants with ratings from a credit rating agency. In our investment niche, which is the market for small and middle-sized company tenants, we are able to underwrite these tenants and thus do not rely on rating agencies. By doing so we avoid the overheated part of the market. We believe that this gives us a competitive advantage.

We are very proud of the accomplishments Gladstone Commercial has achieved over the past year and are excited about the opportunities and challenges that await us in 2007. We remain focused on growing the company while maintaining long-term stockholder value. Preservation of capital is central to our investment strategy. Increasing the monthly dividend is our objective.

We invite you to attend our Company's Annual Meeting scheduled for May 24, 2007 at the Hilton McLean at 7920 Jones Branch Drive, McLean, Virginia at 11:00 a.m.

We thank you for your continued support.



**DAVID GLADSTONE**

*Chairman of the Board of Directors and Chief Executive Officer*



**TERRY BRUBAKER**

*Director, President, Secretary and Chief Operating Officer*



**GEORGE "CHIP" STELLJES III**

*Executive Vice President and Chief Investment Officer*



*“In 2006, we completed the acquisition of nine properties, for a total investment of \$78.5 million.”*

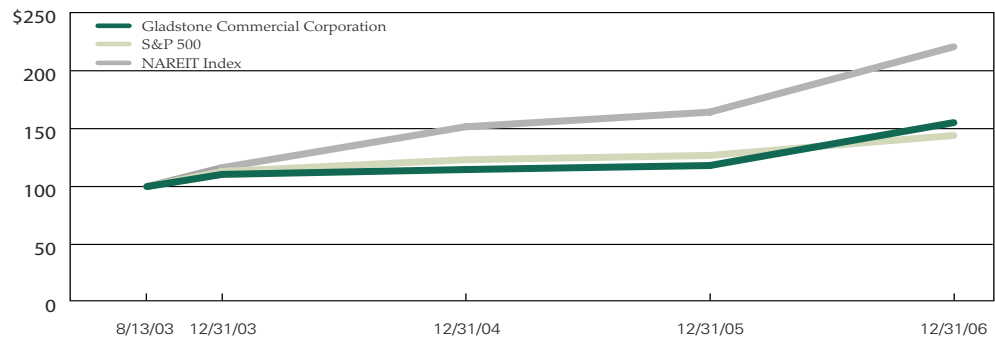


*“In 2006, our FFO was approximately \$9.4 million, or \$1.18 per diluted weighted average share, a 26% increase per share as compared to approximately \$7.3 million, or \$0.94 per diluted weighted average share, one year ago.”*

#### PERFORMANCE MEASUREMENT COMPARISON <sup>(1)</sup>

The following graph shows the total stockholder return on an investment of \$100 in cash on August 13, 2003, the first day of trading of our common stock for (i) our common stock, (ii) the Standards and Poor’s 500 Index (the “S&P 500”) and (iii) the NAREIT Composite Index (the “NAREIT Index”). All values assume reinvestment of the full amount of all dividends:

Comparison Cumulative Total Return on Investment  
(in dollars)



	8/13/03	12/31/03	12/31/04	12/31/05	12/31/06
Gladstone Commercial	\$100.00	\$110.49	\$114.68	\$118.14	\$155.16
S&P 500	\$100.00	\$113.00	\$123.16	\$126.85	\$144.13
NAREIT Index	\$100.00	\$116.30	\$151.67	\$164.24	\$220.66

*(1) This section is not “soliciting material,” is not deemed “filed” with the Securities and Exchange Commission, and is not to be incorporated by reference in any of our filings under the Securities Act of 1933 or the Securities Exchange Act of 1934, whether made before or after the date hereof and irrespective of any general incorporation language contained in any such filing.*



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