

HARTMAN COMMERCIAL PROPERTIES REIT  
Form 10-Q  
November 14, 2006

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549**

**FORM 10-Q**

**QUARTERLY REPORT PURSUANT TO SECTION 13 or 15(d) OF THE SECURITIES EXCHANGE  
ACT OF 1934**

**For the quarterly period ended September 30, 2006**

**OR**

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE  
ACT OF 1934**

**For the transition period from \_\_\_\_\_ to \_\_\_\_\_**

**Commission File Number**

**000-50256**

**HARTMAN COMMERCIAL PROPERTIES REIT**  
(Exact name of registrant as specified in its charter)

**Maryland**  
(State or other jurisdiction of  
incorporation or organization)

**76-0594970**  
(IRS Employer  
Identification No.)

**1450 W. Sam Houston Parkway N., Suite 111  
Houston, Texas 77043**

(Address of principal executive offices)

**(713) 827-9595**

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes

No

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Indicate by checkmark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of “accelerated filer and large accelerated filer” in Rule 12b-2 of the Exchange Act

Large Accelerated Filer

Accelerated Filer

Non-Accelerated Filer

Indicate by checkmark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes

No

The number of the registrant’s Common Shares of Beneficial Interest outstanding at October 31, 2006 was 9,950,839.

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**PART I—FINANCIAL INFORMATION**

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**PART I - FINANCIAL INFORMATION****Item 1. Financial Statements**

## Hartman Commercial Properties REIT and Subsidiary

## CONSOLIDATED BALANCE SHEETS

|   | September 30,<br>2006<br>(Unaudited) | December 31,<br>2005 |
|---|--------------------------------------|----------------------|
| Assets  |                                      |                      |
| Real estate   |                                      |                      |
| Land  | \$ 32,770,566                        | \$ 32,770,566        |
| Buildings and improvements  | 142,246,738                          | 141,018,810          |
|   | 175,017,304                          | 173,789,376          |
| Less accumulated depreciation   | (23,634,941)                         | (19,824,386)         |
| Real estate, net  | 151,382,363                          | 153,964,990          |
| Cash and cash equivalents   | 4,421,731                            | 848,998              |
| Escrows and acquisition deposits  | 1,380,961                            | 5,307,663            |
| Note receivable   | 616,583                              | 628,936              |
| Receivables   |                                      |                      |
| Accounts receivable, net of allowance for doubtful<br>accounts of \$595,568 and \$472,875 as of September 30, 2006<br>and December 31, 2005, respectively | 1,061,717                            | 1,248,985            |
| Accrued rent receivable   | 2,914,848                            | 2,593,060            |
| Due from affiliates   | 2,442,086                            | 3,180,663            |
| Receivables, net  | 6,418,651                            | 7,022,708            |
| Deferred costs, net   | 2,931,752                            | 3,004,218            |
| Prepaid expenses and other assets   | 802,971                              | 684,536              |
| Total assets  | \$ 167,955,012                       | \$ 171,462,049       |

See notes to consolidated financial statements

## Hartman Commercial Properties REIT and Subsidiary

## CONSOLIDATED BALANCE SHEETS (cont.)

|  | September 30,<br>2006<br>(Unaudited) | December 31,<br>2005 |
|--|--------------------------------------|----------------------|
| Liabilities and Shareholders' Equity   |                                      |                      |
| Liabilities  |                                      |                      |
| Notes payable  | \$ 66,601,238                        | \$ 73,025,535        |
| Accounts payable and accrued expenses  | 3,444,364                            | 4,063,126            |
| Due to affiliates  | 265,823                              | 350,865              |
| Tenants' security deposits   | 1,505,316                            | 1,440,864            |
| Prepaid rent   | 605,033                              | 470,248              |
| Offering proceeds escrowed   | 468,390                              | 1,559,439            |
| Dividends payable  | 1,477,394                            | 1,525,460            |
| Other liabilities  | 862,428                              | 1,026,914            |
| <br>Total liabilities  | <br>75,229,986                       | <br>83,462,451       |
| Minority interests of unit holders in Operating Partnership;<br>5,808,337 units at June 30, 2006<br>and December 31, 2005  |                                      |                      |
|  | 32,799,034                           | 34,272,074           |
| <br>Commitments and contingencies  | <br>-                                | <br>-                |
| Shareholders' equity   |                                      |                      |
| Preferred shares, \$0.001 par value per share;<br>50,000,000<br>shares authorized; none issued and outstanding<br>at September 30, 2006 and December 31, 2005                        | -                                    | -                    |
| Common shares, \$0.001 par value per share;<br>400,000,000<br>shares authorized; 9,896,551 and 8,913,654 issued<br>and<br>outstanding at September 30, 2006 and December<br>31, 2005 | 9,897                                | 8,914                |
| Additional paid-in-capital   | 71,283,276                           | 62,560,077           |
| Accumulated deficit  | (11,367,181)                         | (8,841,467)          |
| <br>Total shareholders' equity   | <br>59,925,992                       | <br>53,727,524       |
| <br>Total liabilities and shareholders' equity   | <br>\$ 167,955,012                   | <br>\$ 171,462,049   |

See notes to consolidated financial statements

## Hartman Commercial Properties REIT and Subsidiary

## CONSOLIDATED STATEMENTS OF INCOME

|   | Three Months Ended September 30, |                   | Nine Months Ended September 30, |                     |
|---|----------------------------------|-------------------|---------------------------------|---------------------|
|   | 2006                             | 2005              | 2006                            | 2005                |
|   | (Unaudited)                      |                   | (Unaudited)                     |                     |
| <b>Revenues</b>   |                                  |                   |                                 |                     |
| Rental income   | \$ 6,318,272                     | \$ 4,967,156      | \$ 18,451,651                   | \$ 14,785,885       |
| Tenants' reimbursements                                       | 1,122,530                        | 1,055,734         | 3,722,817                       | 3,603,535           |
| Interest and other income                                     | 35,641                           | 181,739           | 589,196                         | 398,258             |
| <b>Total revenues</b>   | <b>7,476,443</b>                 | <b>6,204,629</b>  | <b>22,763,664</b>               | <b>18,787,678</b>   |
| <b>Expenses</b>   |                                  |                   |                                 |                     |
| Operation and maintenance                                     | 974,191                          | 943,609           | 3,049,230                       | 2,491,107           |
| Interest expense  | 1,228,724                        | 970,109           | 3,939,206                       | 2,651,906           |
| Real estate taxes   | 921,217                          | 826,638           | 2,755,663                       | 2,391,661           |
| Insurance   | 169,877                          | 110,516           | 451,290                         | 331,973             |
| Electricity, water and gas utilities                          | 645,646                          | 251,379           | 1,758,384                       | 724,574             |
| Property management and asset management fees to an affiliate | 556,283                          | 323,517           | 1,359,903                       | 1,052,679           |
| General and administrative                                    | 371,884                          | 334,824           | 1,109,740                       | 955,665             |
| Depreciation  | 1,271,854                        | 1,109,772         | 3,810,550                       | 3,186,910           |
| Amortization  | 233,988                          | 353,868           | 969,202                         | 1,089,696           |
| Bad debt expense  | 129,189                          | 86,225            | 247,339                         | 155,785             |
| <b>Total expenses</b>   | <b>6,502,853</b>                 | <b>5,310,457</b>  | <b>19,450,507</b>               | <b>15,031,956</b>   |
| <b>Income before minority interests</b>                       | <b>973,590</b>                   | <b>894,172</b>    | <b>3,313,157</b>                | <b>3,755,722</b>    |
| <b>Minority interests in Operating Partnership</b>            | <b>(371,176)</b>                 | <b>(382,662)</b>  | <b>(1,287,552)</b>              | <b>(1,669,492)</b>  |
| <b>Net income</b>   | <b>\$ 602,414</b>                | <b>\$ 511,510</b> | <b>\$ 2,025,605</b>             | <b>\$ 2,086,230</b> |
| <b>Net income per common share</b>                            | <b>\$ 0.061</b>                  | <b>\$ 0.064</b>   | <b>\$ 0.212</b>                 | <b>\$ 0.273</b>     |
| <b>Weighted-average shares outstanding</b>                    | <b>9,829,709</b>                 | <b>8,014,097</b>  | <b>9,548,174</b>                | <b>7,645,483</b>    |



See notes to consolidated financial statements

## Hartman Commercial Properties REIT and Subsidiary

## CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

|  | Common Stock |          | Additional         | Accumulated     | Total         |
|--|--------------|----------|--------------------|-----------------|---------------|
|  | Shares       | Amount   | Paid-in<br>Capital | Deficit         |               |
| Balance, December 31,<br>2004  | 7,010,146    | \$ 7,010 | \$ 45,527,152      | \$ (5,705,170)  | \$ 39,828,992 |
| Issuance of common stock<br>for<br>cash, net of offering costs                   | 1,865,557    | 1,866    | 16,672,428         | -               | 16,674,294    |
| Issuance of shares under<br>dividend<br>reinvestment plan at \$9.50<br>per share | 37,951       | 38       | 360,497            | -               | 360,535       |
| Net income   | -            | -        | -                  | 2,448,182       | 2,448,182     |
| Dividends  | -            | -        | -                  | (5,584,479)     | (5,584,479)   |
| Balance, December 31,<br>2005  | 8,913,654    | 8,914    | 62,560,077         | (8,841,467)     | 53,727,524    |
| Issuance of common stock<br>for<br>cash, net of offering costs                   | 910,756      | 911      | 8,037,931          | -               | 8,038,842     |
| Issuance of shares under<br>dividend<br>reinvestment plan at \$9.50<br>per share | 72,141       | 72       | 685,268            | -               | 685,340       |
| Net income   | -            | -        | -                  | 2,025,605       | 2,025,605     |
| Dividends  | -            | -        | -                  | (4,551,319)     | (4,551,319)   |
| Balance, September 30,<br>2006 (unaudited)                                       | 9,896,551    | \$ 9,897 | \$ 71,283,276      | \$ (11,367,181) | \$ 59,925,992 |

See notes to consolidated financial statements

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## Hartman Commercial Properties REIT and Subsidiary

## CONSOLIDATED STATEMENTS OF CASH FLOWS

|   | Nine Months Ended September 30, |              |
|---|---------------------------------|--------------|
|   | 2006                            | 2005         |
|   | (Unaudited)                     |              |
| Cash flows from operating activities:   |                                 |              |
| Net income  | \$ 2,025,605                    | \$ 2,086,230 |
| Adjustments to reconcile net income to net cash provided by (used in) operating activities: |                                 |              |
| Depreciation  | 3,810,550                       | 3,186,910    |
| Amortization  | 969,202                         | 1,089,696    |
| Minority interests in Operating Partnership   | 1,287,552                       | 1,669,492    |
| Equity in income of real estate partnership   | -                               | (4,805)      |
| Bad debt expense  | 247,339                         | 155,785      |
| Fair value of derivative instrument   | (3,742)                         | -            |
| Changes in operating assets and liabilities:  |                                 |              |
| Escrows and acquisition deposits  | 3,926,702                       | 365,594      |
| Receivables   | (381,859)                       | (267,871)    |
| Due from affiliates   | 653,535                         | (317,594)    |
| Deferred costs  | (777,200)                       | (1,760,705)  |
| Prepaid expenses and other assets   | (118,435)                       | (101,875)    |
| Accounts payable and accrued expenses   | (661,900)                       | (358,468)    |
| Tenants' security deposits  | 64,452                          | 212,630      |
| Prepaid rent  | 134,785                         | 119,079      |
| Net cash provided by operating activities   | 11,176,586                      | 6,074,098    |
| Cash flows from investing activities:   |                                 |              |
| Additions to real estate  | (1,227,928)                     | (14,019,057) |
| Distributions received from real estate partnership   | -                               | 9,743        |
| Repayment of note receivable  | 12,353                          | 15,931       |
| Net cash used in investing activities   | (1,215,575)                     | (13,993,383) |
| Cash flows from financing activities:   |                                 |              |
| Dividends paid  | (4,553,412)                     | (3,870,382)  |
| Distributions paid to OP unit holders   | (2,925,078)                     | (3,073,191)  |
| Proceeds from issuance of common shares   | 8,724,182                       | 9,889,860    |
| Increase (decrease) in stock offering proceeds escrowed                                     | (1,091,049)                     | 13,496       |
| Proceeds from notes payable   | 35,280,406                      | 30,775,322   |
| Repayments of notes payable   | (41,703,787)                    | (24,553,249) |
| Payments of loan origination costs  | (119,540)                       | (328,194)    |

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|   |              |              |
|---|--------------|--------------|
| Net cash provided by (used in) financing activities | (6,388,278)  | 8,853,662    |
| Net increase in cash and cash equivalents           | 3,572,733    | 934,377      |
| Cash and cash equivalents at beginning of period    | 848,998      | 631,978      |
| Cash and cash equivalents at end of period          | \$ 4,421,731 | \$ 1,566,355 |

See notes to consolidated financial statements

Hartman Commercial Properties REIT and Subsidiary  
Notes to Consolidated Financial Statements (Unaudited)  
September 30, 2006

**Note 1 - Summary of Significant Accounting Policies**

The consolidated financial statements included in this report are unaudited; however, amounts presented in the balance sheet as of December 31, 2005 are derived from the audited consolidated financial statements of the Company (defined below) at that date. The unaudited financial statements at September 30, 2006 have been prepared in accordance with U.S. generally accepted accounting principles for interim financial information on a basis consistent with the annual audited consolidated financial statements and with the instructions to Form 10-Q. Accordingly, they do not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements. The consolidated financial statements presented herein reflect all adjustments which, in the opinion of management, are necessary for a fair presentation of the financial position of Hartman Commercial Properties REIT ("HCP") and its subsidiary as of September 30, 2006 and results of operations for the three and nine month periods ended September 30, 2006 and cash flows for the nine month period ended September 30, 2006. All such adjustments are of a normal recurring nature. The results of operations for the interim period are not necessarily indicative of the results expected for a full year. The statements should be read in conjunction with the audited consolidated financial statements and footnotes thereto included in HCP's Annual Report on Form 10-K.

Description of business and nature of operations

HCP was formed as a real estate investment trust, pursuant to the Texas Real Estate Investment Trust Act on August 20, 1998. In July 2004, HCP changed its state of organization from Texas to Maryland pursuant to a merger of HCP directly with and into a Maryland real estate investment trust formed for the sole purpose of the reorganization and the conversion of each outstanding common share of beneficial interest of the Texas entity into 1.42857 common shares of beneficial interest of the Maryland entity. HCP serves as the general partner of Hartman REIT Operating Partnership, L.P. (the "Operating Partnership" or "HROP" or "OP"), which was formed on December 31, 1998 as a Delaware limited partnership. HCP and the Operating Partnership are collectively referred to herein as the "Company." HCP currently conducts substantially all of its operations and activities through the Operating Partnership. As the general partner of the Operating Partnership, HCP has the exclusive power to manage and conduct the business of the Operating Partnership, subject to certain customary exceptions. As of September 30, 2006 and December 31, 2005, the Company owned and operated 37 retail, office/warehouse and office properties in and around Houston, Dallas and San Antonio, Texas.

Basis of consolidation

HCP is the sole general partner of the Operating Partnership and possesses full legal control and authority over the operations of the Operating Partnership. As of September 30, 2006 and December 31, 2005, HCP owned a majority of the partnership interests in the Operating Partnership. Consequently, the accompanying consolidated financial statements of the Company include the accounts of the Operating Partnership. All significant intercompany balances have been eliminated. Minority interest in the accompanying consolidated financial statements represents the share of equity and earnings of the Operating Partnership allocable to holders of partnership interests other than HCP. Net income is allocated to minority interests based on the weighted-average percentage ownership of the Operating Partnership during the year. Issuance of additional common shares of beneficial interest in HCP ("common shares") and units of limited partnership interest in the Operating Partnership ("OP Units") changes the ownership interests of both the minority interests and HCP.



Hartman Commercial Properties REIT and Subsidiary  
Notes to Consolidated Financial Statements (Unaudited)  
September 30, 2006

**Note 1 -**

**Summary of Significant Accounting Policies**

Basis of accounting

The financial records of the Company are maintained on the accrual basis of accounting whereby revenues are recognized when earned, and expenses are recorded when incurred.

Cash and cash equivalents

The Company considers all highly liquid debt instruments purchased with an original maturity of three months or less to be cash equivalents. Cash and cash equivalents at September 30, 2006 and December 31, 2005 consist of demand deposits at commercial banks and money market funds.

Due from affiliates

Due from affiliates includes amounts owed to the Company from limited partnerships and other entities affiliated with Hartman Management, L.P. ("Hartman Management") the former investment adviser of the Company.

Escrows and acquisition deposits

Escrow deposits include escrows established pursuant to certain mortgage financing arrangements for real estate taxes, insurance, maintenance and capital expenditures and escrow of proceeds of the Public Offering described in Note 6 prior to shares being issued for those proceeds. Acquisition deposits include earnest money deposits on future acquisitions.

Real estate

Real estate properties are recorded at cost, net of accumulated depreciation. Improvements, major renovations and certain costs directly related to the acquisition, improvement and leasing of real estate are capitalized. Expenditures for repairs and maintenance are charged to operations as incurred. Depreciation is computed using the straight-line method over the estimated useful lives of 5 to 39 years for the buildings and improvements. Tenant improvements are depreciated using the straight-line method over the life of the lease.

Management reviews its properties for impairment whenever events or changes in circumstances indicate that the carrying amount of the assets, including accrued rental income, may not be recoverable through operations. Management determines whether an impairment in value has occurred by comparing the estimated future cash flows (undiscounted and without interest charges), including the estimated residual value of the property, with the carrying cost of the property. If impairment is indicated, a loss will be recorded for the amount by which the carrying value of the property exceeds its fair value. Management has determined that there has been no impairment in the carrying value of the Company's real estate assets as of September 30, 2006 and December 31, 2005.

Deferred costs

Deferred costs consist primarily of leasing commissions, historically paid to Hartman Management and deferred financing costs. Leasing commissions are amortized using the straight-line method over the terms of the related lease agreements. Deferred financing costs are amortized using the straight-line method over the terms of the loans, which



approximates the interest method. Costs allocated to in-place leases whose terms differ from market terms related to acquired properties are amortized over the remaining life of the respective leases.

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Hartman Commercial Properties REIT and Subsidiary  
Notes to Consolidated Financial Statements (Unaudited)  
September 30, 2006

**Note 1 - Summary of Significant Accounting Policies (continued)**

Offering costs

Offering costs include selling commissions, issuance costs, investor relations fees and unit purchase discounts. These costs were incurred in the raising of capital through the sale of common shares and are treated as a reduction of shareholders' equity.

Revenue recognition

All leases on properties held by the Company are classified as operating leases, and the related rental income is recognized on a straight-line basis over the terms of the related leases. Differences between rental income earned and amounts due per the respective lease agreements are capitalized or charged, as applicable, to accrued rent receivable. Percentage rents are recognized as rental income when the thresholds upon which they are based have been met. Recoveries from tenants for taxes, insurance, and other operating expenses are recognized as revenues in the period the corresponding costs are incurred. The Company provides an allowance for doubtful accounts against the portion of tenant accounts receivable which is estimated to be uncollectible.

Federal income taxes

The Company is qualified as a real estate investment trust ("REIT") under the Internal Revenue Code of 1986 and is therefore not subject to Federal income taxes provided it meets all conditions specified by the Internal Revenue Code for retaining its REIT status. The Company believes it has continuously met these conditions since reaching 100 shareholders in 1999.

Use of estimates

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Significant estimates used by the Company include the estimated useful lives for depreciable and amortizable assets and costs, impairment of real estate assets and the estimated allowance for doubtful accounts receivable. Actual results could differ from those estimates.

Derivative Instruments

The Company has initiated a program designed to manage exposure to interest rate fluctuations by entering into financial derivative instruments. The primary objective of this program is to comply with debt covenants on a credit facility. The Company entered into an interest rate swap agreement with respect to amounts borrowed under certain of our credit facilities, which effectively exchanges existing obligations to pay interest based on floating rates for obligations to pay interest based on fixed LIBOR rates.

Changes in the market value of the derivative instruments and in the market value of the hedged items are recorded in earnings each reporting period. For items that are appropriately classified as cash flow hedges in accordance with Statement of Financial Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging Activities," changes in the market value of the instrument and in the market value of the hedged item are recorded as

other comprehensive income with the exception of the portion of the hedged items that are considered ineffective. The derivative instruments are reported at fair value as other assets or other liabilities as applicable. As of September 30, 2006, the fair value of this instrument is approximately (\$4,000) and is included in prepaid expenses and other assets in the consolidated balance sheet. Additionally, approximately (\$4,000) is included in interest and other income on the consolidated statements of income for the nine months ended September 30, 2006.

Hartman Commercial Properties REIT and Subsidiary  
Notes to Consolidated Financial Statements (Unaudited)  
September 30, 2006

**Note 1 - Summary of Significant Accounting Policies (continued)**

Fair value of financial instruments

The Company's financial instruments consist primarily of cash, cash equivalents, accounts receivable, accounts and notes payable. The carrying value of cash, cash equivalents, accounts receivable and accounts payable are representative of their respective fair values due to the short-term nature of these instruments. The fair value of the Company's debt obligations is representative of its carrying value based upon current rates offered for similar types of borrowing arrangements. The fair value of interest rate swaps (used for hedging purposes) is the estimated amount that the financial institution would receive or pay to terminate the swap agreements at the reporting date, taking into account current interest rates and the current creditworthiness of the swap counterparties.

Recent accounting pronouncements

In May 2005, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 154 *Accounting Changes and Error Corrections - A Replacement of APB Opinion No. 2 and FASB Statement No. 3*. ("SFAS 154"). This statement changes the requirements for the accounting for and reporting of a change in accounting principle. This statement applies to all voluntary changes in accounting principles. It also applies to changes required by an accounting pronouncement in the unusual instance that the pronouncement does not include specific transition provisions. When a pronouncement includes specific transition provisions, those provisions should be followed. This statement is effective for fiscal years beginning after December 15, 2005 and did not have a material impact on the Company's consolidated financial statements.

In February 2006, the FASB issued SFAS No. 155, *Accounting for Certain Hybrid Financial Instruments an amendment of FASB Statements No. 133 and 140* ("SFAS 155"). This statement will be effective beginning the first quarter of 2007. Earlier adoption is permitted. The statement permits interests in hybrid financial assets that contain an embedded derivative that would require bifurcation to be accounted for as a single financial instrument at fair value with changes in fair value recognized in earnings. This election is permitted on an instrument-by-instrument basis for all hybrid financial instruments held, obtained, or issued as of the adoption date. The Company is currently assessing the impact and timing of adoption of SFAS 155.

In March 2006, FASB issued SFAS No. 156, *Accounting for Servicing of Financial Assets - an amendment of FASB Statement No. 140*, ("SFAS 156"), which permits entities to elect to measure servicing assets and servicing liabilities at fair value and report changes in fair value in earnings. Adoption of SFAS 156 is required for financial periods beginning after September 15, 2006. The Company is currently assessing the impact and timing of adoption of SFAS 156 but does not expect the standard to have a material impact on the consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* ("SFAS 157"). SFAS 157 defines fair value, establishes a framework for measuring fair value under U.S. generally accepted accounting principles and requires enhanced disclosures about fair value measurements. It does not require any new fair value measurements. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. The Company is currently assessing whether to early adopt SFAS 157 as of the first quarter of fiscal 2007 as permitted, and is currently evaluating the impact adoption may have on the consolidated financial statements.



Hartman Commercial Properties REIT and Subsidiary  
Notes to Consolidated Financial Statements (Unaudited)  
September 30, 2006

**Note 1 - Summary of Significant Accounting Policies (continued)**

Concentration of risk

Substantially all of the Company's revenues are obtained from retail, office/warehouse and office locations in the Houston, Dallas and San Antonio, Texas metropolitan areas.

The Company maintains cash accounts in major financial institutions in the United States. The terms of these deposits are on demand to minimize risk. The balances of these accounts regularly exceed the federally insured limits, although no losses have been incurred in connection with such cash balances.

Restatement

Subsequent to September 30, 2006, but before the completion of the review for the quarter ended September 30, 2006, management determined that deferred commissions related to an early lease termination on March 28, 2006 were not charged to operations. In accordance with Company policy, deferred lease commissions for tenants that pre-maturely vacate a lease are to be charged to amortization expense in the period in which the default occurs. Accordingly, the Consolidated Balance Sheets as of March 31, 2006 and June 30, 2006 and the Consolidated Statements of Operations for the three months ended March 31, 2006 and the six months ended June 30, 2006 have been restated. See Note 10.

Comprehensive income

The Company follows SFAS No. 130, "*Reporting Comprehensive Income*," which establishes standards for reporting and display for comprehensive income and its components. For the periods presented, the Company did not have significant amounts of other comprehensive income.

**Note 2 - Interest Rate Swap**

Effective March 16, 2006, the Company executed an interest rate swap used to mitigate the risks associated with adverse movements in interest rates which might affect expenditures. The Company has not designated this derivative contract as a hedge, and as such, the change in the fair value of the derivative is recognized currently in earnings. This derivative instrument has a total notional amount of \$30,000,000, is at a fixed rate of 5.09% plus the LIBOR margin (see Note 3), and matures monthly through March, 2008. As of September 30, 2006, the fair value of this instrument is approximately (\$4,000) and is included in prepaid expenses and other assets in the consolidated balance sheet and interest and other income in the consolidated statements of income.

**Note 3 - Debt**

Notes Payable

Mortgages and other notes payable consist of the following:

|  | September 30,<br>2006 | December 31,<br>2005 |
|--|-----------------------|----------------------|
|--|-----------------------|----------------------|

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|                                      |    |            |    |            |
|--------------------------------------|----|------------|----|------------|
| Mortgages and other notes payable    | \$ | 5,226,826  | \$ | 40,050,441 |
| Revolving loan secured by properties |    | 61,225,094 |    | 32,975,094 |
| Insurance premium finance note       |    | 149,318    |    | -          |
| Total                                | \$ | 66,601,238 | \$ | 73,025,535 |

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Hartman Commercial Properties REIT and Subsidiary  
 Notes to Consolidated Financial Statements (Unaudited)  
 September 30, 2006

**Note 3 -**

**Debt (continued)**

The Company has a revolving credit facility with a consortium of banks. The credit facility is secured by a pledge of the partnership interests in Hartman REIT Operating Partnership III LP (“HROP III”), a wholly owned subsidiary of the Operating Partnership that was formed to hold title to the properties comprising the borrowing base pool for the facility. At that time, there were 18 properties owned by HROP III.

The original limit of the credit facility was \$50,000,000, and it may be increased to \$100,000,000 as the borrowing base pool expands. The Company entered into this credit facility to refinance its then existing debt, to finance property acquisitions and for general corporate purposes.

On May 31, 2006, pursuant to the Revolving Credit Agreement, dated as of March 11, 2005, the Company requested to increase the limit of the credit facility by \$25,000,000, so that the total credit facility will be \$75,000,000.

On June 26, 2006, the Company conveyed ownership of 18 properties from Hartman REIT Operating Partnership II LP (“HROP II”) to HROP III in order to expand the borrowing base pool for the credit facility. At September 30, 2006, 36 properties were owned by HROP III.

On June 30, 2006, the Company drew down \$34,750,000 on the line of credit to extinguish the three year floating rate mortgage loan described below and pay related legal and banking fees.

As of September 30, 2006 and December 31, 2005, the balance outstanding under the facility was \$61,225,094 and \$32,975,094, respectively, and the availability to draw was \$13,774,906 and \$17,024,906, respectively.

Outstanding amounts under the credit facility accrue interest computed (at the Company’s option) at either the LIBOR or the Alternative Base Rate on the basis of a 360 day year, plus the applicable margin as determined from the following table:

| Total Leverage Ratio                           | LIBOR<br>Margin | Alternative<br>Base<br>Rate Margin |
|--|-----------------|------------------------------------|
| Less than 60% but greater than or equal to 50% | 2.40%           | 1.150%                             |
| Less than 50% but greater than or equal to 45% | 2.15%           | 1.025%                             |
| Less than 45%                                  | 1.90%           | 1.000%                             |

The Alternative Base Rate is a floating rate equal to the higher of the bank’s base rate or the Federal Funds Rate plus .5%. LIBOR Rate loans will be available in one, two, three or nine month periods, with a maximum of nine contracts at any time. The effective interest rate as of September 30, 2006 was 7.22% per annum.

Interest only is payable monthly under the loan with the total amount of principal due at maturity on March 11, 2008. The loan may be prepaid at any time in part or in whole, provided that the credit facility is not in default. If LIBOR



pricing is elected, there is a prepayment penalty based on a “make-whole” calculation for all costs associated with prepaying a LIBOR borrowing.

Hartman Commercial Properties REIT and Subsidiary  
Notes to Consolidated Financial Statements (Unaudited)  
September 30, 2006

**Note 3 -**

**Debt (continued)**

As of December 31, 2005, the Company was in violation of a loan covenant which provides that the ratio of declared dividends to funds from operations (as defined in the loan agreement) shall not be greater than 95%. As this violation constitutes an event of default, the lenders had the right to accelerate payment of this credit facility. However, on May 8, 2006 the Company received a waiver from the required majority of the consortium banks in the credit facility and also entered into a modification of the loan agreement whereby the covenant was amended through December 31, 2006. As amended, the ratio of declared dividends to funds from operations (as defined in the loan agreement) shall not exceed 107% for the three months ended March 31, 2006 and June 30, 2006, 104% for the three months ended September 30, 2006 and 100% for the three months ended December 31, 2006. The Company is now in compliance with the covenant, as amended.

On October 2, 2006, the Company's Board of Trustees (the "Board") (i) elected not to renew an Advisory Agreement between the Company and Hartman Management pursuant to which Hartman Management had previously managed, among other things, the Company's acquisition and disposition programs, financing activities and accounting and back-office operations; (ii) provided verbal notice, followed by written notice, that it was terminating a certain Amended and Restated Property Management Agreement between the Company and Hartman Management pursuant to which Hartman Management had historically managed the leasing and operation of the Company's real properties; and (iii) removed the Company's chairman and chief executive officer, Allen R. Hartman, who is also the chief executive officer and sole owner of Hartman Management, from his positions as chairman, president, secretary and chief executive officer of the Company. These actions violated certain covenants in the loan agreement and were events of default thereunder. On October 31, 2006, the Company gave written notice to its lenders of the foregoing events of default and requested that the lenders waive such defaults. On November 9, 2006, the lenders granted a temporary waiver of such events of default until February 1, 2007, which waiver will become permanent at such time so long as (1) the Company timely delivers to the lenders all financial statements, certificates and other financial information required by the loan agreement, and (2) KeyBank, as agent for the lenders, is satisfied with the Company's ability to manage its real estate portfolio without the benefit of an external property manager.

In December 2002, the Company refinanced substantially all of its mortgage debt with a \$34,440,000 three-year floating rate mortgage loan collateralized by 18 of the then existing Company's properties and having a maturity date of January 1, 2006, extendable for an additional two years. Effective as of February 28, 2006 we extended the loan to January 1, 2008. During the initial term, the loan bore interest at 2.5% over a 30-day LIBOR (6.79% at December 31, 2005) computed on the basis of a 360-day year. During the extension term the interest rate will be 3.0% over 30-day LIBOR. Interest only payments are due monthly, and the loan may be repaid in full or in \$100,000 increments, with a final balloon payment due upon maturity.

The security documents related to the mortgage loan contain a covenant that requires HROP II, a wholly owned subsidiary formed for the purpose of this credit facility, to maintain adequate capital in light of its contemplated operations. This covenant and the other restrictions provided for in the credit facility do not affect HROP II's ability to make distributions to the Company. On June 30, 2006, the Company paid off the balance of this loan.

In connection with the purchase of the Windsor Park property in December 2003, the Company assumed a note payable in the amount of \$6,550,000, secured by the property. The balance at September 30, 2006 was \$5,226,826. The note is payable in equal monthly installments of principal and interest of \$80,445, with interest at the rate of 8.34% per annum. The balance of the note is payable in full on December 1, 2006. The Company is in process of obtaining new financing to pay this note.

The Company financed its comprehensive insurance premium with a note in the amount of \$757,175 payable in 10 equal monthly installments of \$75,718, which includes interest at 5.49%. The note is secured by unearned insurance premiums and will be paid in full in December 2006.

Hartman Commercial Properties REIT and Subsidiary  
Notes to Consolidated Financial Statements (Unaudited)  
September 30, 2006

**Note 3 -****Debt (continued)**

As of September 30, 2006, annual maturities of notes payable, including the revolving loan, are as follows:

| Year<br>Ended<br>September<br>30, |               |
|-----------------------------------|---------------|
| 2007                              | \$ 5,376,144  |
| 2008                              | 61,225,094    |
|                                   | \$ 66,601,238 |

Supplemental Cash Flow Information

The Company made cash payments for interest on debt of \$1,193,960 and \$970,109 for the three months ended September 30, 2006 and 2005, respectively, and \$3,907,114 and \$2,651,906 for the nine months ended September 30, 2006 and 2005, respectively.

**Note 4 -****Earnings Per Share**

Basic earnings per share is computed using net income available to common shareholders and the weighted average number of common shares outstanding. Diluted earnings per share reflects common shares issuable from the assumed conversion of units of limited partnership interests in the Operating Partnership ("OP Units") that are convertible into common shares on a one for one basis. Only those items that have a dilutive impact on basic earnings per share are included in the diluted earnings per share. Accordingly, excluded from the earnings per share calculation for each of the three and nine months ended September 30, 2006 and 2005 are 5,808,337 OP Units as their inclusion would be anti-dilutive.

|  | Three Months Ended September |            | Nine Months Ended September |              |
|--|------------------------------|------------|-----------------------------|--------------|
|  | 2006                         | 2005       | 2006                        | 2005         |
| Basic and diluted earnings per share       |                              |            |                             |              |
| Weighted average common shares outstanding | 9,829,709                    | 8,014,097  | 9,548,174                   | 7,645,483    |
| Basic and diluted earnings per share       | \$ 0.061                     | \$ 0.064   | \$ 0.212                    | \$ 0.273     |
| Net income                                 | \$ 602,414                   | \$ 511,510 | \$ 2,025,605                | \$ 2,086,230 |



Hartman Commercial Properties REIT and Subsidiary  
Notes to Consolidated Financial Statements (Unaudited)  
September 30, 2006

**Note 5 -**

**Related-Party Transactions**

In January 1999, the Company entered into a property management agreement with Hartman Management. Effective September 1, 2004, this agreement was amended and restated. Prior to September 1, 2004, in consideration for supervising the management and performing various day-to-day affairs, the Company paid Hartman Management a management fee of 5% and a partnership management fee of 1% based on Effective Gross Revenues from the properties, as defined. After September 1, 2004, the Company pays Hartman Management property management fees in an amount not to exceed the fees customarily charged in arm's length transactions by others rendering similar services in the same geographic area, as determined by a survey of brokers and agents in such area. These fees have ranged between approximately 2% and 4% of Gross Revenues, as such term is defined in the amended and restated property management agreement, for the management of office buildings and approximately 5% of Gross Revenues for the management of retail and office/industrial properties. On October 2, 2006, the Board gave verbal notice to Hartman Management of the Company's termination of the property management agreement, followed by written notice on October 9, 2006. Hartman Management has agreed to turn all property management functions over to the Company on November 14, 2006.

Effective September 1, 2004, the Company entered into an advisory agreement with Hartman Management which provides that the Company pay Hartman Management a quarterly fee of one-fourth of .25% of Gross Asset Value, as such term is defined in the advisory agreement, for asset management services. In addition, the advisory agreement provided for the payment of a deferred performance fee, payable in certain events, including termination of the advisory agreement, based upon appreciation in the value of certain real estate assets owned by the Company. The advisory agreement expired by its terms on September 30, 2006, and on October 2, 2006, the Board elected not to renew the advisory agreement.

The Company incurred total management, partnership and asset management fees of \$556,283 and \$323,517 for the three months ended September 30, 2006 and 2005, respectively, and \$1,359,903 and \$1,052,679 for the nine months ended September 30, 2006 and 2005, respectively. Such fees in the amounts of \$184,066 and \$111,286 were payable to Hartman Management at September 30, 2006 and December 31, 2005, respectively. The Company has not accrued any deferred performance fees, as it believes the amount of such fees, if any are owing, cannot be determined with reasonable certainty at this time.

The aggregate fees and reimbursements payable to Hartman Management under the new agreements effective September 1, 2004 were not intended to be significantly different from those that would have been payable under the previous agreement. Upon actual calculation, the asset management fee under the new agreement was significantly higher. Hartman Management waived the excess of the fee for the period September 1, 2004 through March 31, 2006 in perpetuity. The asset management fee, as calculated under the new agreement, was charged by Hartman Management in the second and third quarters and has been reflected in the consolidated financial statements as of September 30, 2006.

During July 2004, the Company amended certain terms of its Declaration of Trust. Under the amended terms, Hartman Management may be required to reimburse the Company for operating expenses exceeding certain limitations determined at the end of each fiscal quarter. Reimbursements, if any, from Hartman Management are recorded on a quarterly basis as a reduction in property management fees.

Under the provisions of the property management agreement, costs incurred by Hartman Management for the management and maintenance of the properties are reimbursable to Hartman Management. At September 30, 2006 and December 31, 2005, \$144 and \$51,675, respectively, were payable to Hartman Management related to these

reimbursable costs.

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Hartman Commercial Properties REIT and Subsidiary  
Notes to Consolidated Financial Statements (Unaudited)  
September 30, 2006

**Note 5 - Related-Party Transactions (continued)**

In consideration of leasing the properties, the Company also pays Hartman Management leasing commissions for leases originated by Hartman Management and for expansions and renewals of existing leases. The Company incurred total leasing commissions to Hartman Management of \$159,753 and \$325,610 for the three months ended September 30, 2006 and 2005, respectively, and \$777,200 and \$1,350,410 for the nine months ended September 30, 2006 and 2005, respectively. At September 30, 2006 and December 31, 2005, \$48,476 and \$78,744, respectively, were payable to Hartman Management relating to leasing commissions.

In connection with the Public Offering described in Note 6, the Company has reimbursed Hartman Management up to 2.5% of the gross selling price of all common shares sold for organization and offering expenses (excluding selling commissions and a dealer manager fee) incurred by Hartman Management on behalf of the Company. The Company has paid its dealer manager, through Hartman Management by agreement between them, a fee of up to 2.5% of the gross selling price of all common shares sold in the offering. The Company incurred total fees of \$39,142 and \$87,169 for the three months ended September 30, 2006 and 2005, respectively, and \$201,659 and \$280,636 for the nine months ended September 30, 2006 and 2005, respectively. Such fees have been treated as offering costs and netted against the proceeds from the sale of common shares. On October 2, 2006, the Board elected to suspend the Public Offering described in Note 6. Due to the expiration of the advisory agreement, if the Public Offering is re-commenced at a later time, Hartman Management will not be paid additional fees in connection with the sale of securities.

Also in connection with the Public Offering described in Note 6, Hartman Management has historically received an acquisition fee equal to 2% of the gross selling price of all common shares sold for services in connection with the selection, purchase, development or construction of properties for the Company. The Company has capitalized this acquisition fee and will allocate it to the purchase price of properties acquired with offering proceeds.

The Company incurred total acquisition fees to Hartman Management of \$31,313 and \$69,733 for the three months ended September 30, 2006 and 2005, respectively, and \$161,627 and \$224,508 for the nine months ended September 30, 2006 and 2005, respectively. At September 30, 2006 and December 31, 2005, \$33,137 and \$109,160, respectively, were payable to Hartman Management relating to organization and offering expenses, dealer manager fees and acquisition fees.

Hartman Management was billed \$28,857 and \$18,135 to the Company for office space during the three months ended September 30, 2006 and 2005, respectively, and \$75,817 and \$60,626 for the nine months ended September 30, 2006 and 2005, respectively. Such amounts are included in rental income in the consolidated statements of income.

HCP's day-to-day operations are strategically directed by the Board. HCP owns substantially all of its real estate properties through the Operating Partnership. Hartman was the HCP's Board Chairman through October 2, 2006. He is also the sole owner of Hartman Management. Hartman was owed \$68,120 and \$47,478 in dividends payable on his common shares at September 30, 2006 and December 31, 2005, respectively. Hartman owned 3.1% of the issued and outstanding common shares of the Company as of September 30, 2006 and December 31, 2005, respectively.

The Company was a party to various other transactions with related parties which are reflected in due to/from affiliates in the accompanying consolidated balance sheets.





Hartman Commercial Properties REIT and Subsidiary  
Notes to Consolidated Financial Statements (Unaudited)  
September 30, 2006

**Note 6 -**

**Shareholders' Equity**

Under its Articles of Amendment and Restatement in effect, HCP has authority to issue 400,000,000 common shares of beneficial interest, \$0.001 par value per share, and 50,000,000 preferred shares of beneficial interest, \$0.001 par value per share.

On September 15, 2004, HCP's Registration Statement on Form S-11, with respect to a public offering (the "Public Offering") of up to 10,000,000 common shares of beneficial interest to be offered at a price of \$10 per share was declared effective under the Securities Act of 1933. The Registration Statement also covers up to 1,000,000 shares available pursuant to HCP's dividend reinvestment plan to be offered at a price of \$9.50 per share. The shares are offered to investors on a best efforts basis. Post-Effective Amendments No. 1, 2 and 3 to the Registration Statement were declared effective by the SEC on June 27, 2005, March 9, 2006 and May 3, 2006, respectively.

As of September 30, 2006, 2,776,313 shares had been issued pursuant to the Public Offering with net offering proceeds received of \$24,189,173. An additional 110,092 shares had been issued pursuant to the dividend reinvestment plan in lieu of dividends totaling \$1,045,874. On October 2, 2006, the Board suspended the Public Offering.

At September 30, 2006 and December 31, 2005, Hartman and the Board collectively owned 5.70% and 5.95%, respectively, of HCP's outstanding shares.

Operating Partnership units

Limited partners in the Operating Partnership holding OP Units have the right to convert their OP Units into common shares at a ratio of one OP Unit for one common share. Distributions to OP Unit holders are paid at the same rate per unit as dividends per share of HCP. Subject to certain restrictions, OP Units are not convertible into common shares until the later of one year after acquisition or an initial public offering of the common shares. As of September 30, 2006 and December 31, 2005, there were 15,343,400 and 14,360,503 OP Units outstanding, respectively. HCP owned 9,535,063 and 8,552,166 Units as of September 30, 2006 and December 31, 2005, respectively. The balance of the OP Units are owned by third parties, including Mr. Hartman and certain trustees. HCP's weighted-average share ownership in the Operating Partnership was approximately 61.99% and 56.80% during the three months ended September 30, 2006 and 2005, respectively, and 61.26% and 55.59% for the nine months ended September 30, 2006 and 2005, respectively. At September 30, 2006 and December 31, 2005, Hartman and the Board of Trustees collectively owned 7.37% and 7.82% of the Operating Partnership's outstanding units.



Hartman Commercial Properties REIT and Subsidiary  
Notes to Consolidated Financial Statements (Unaudited)  
September 30, 2006

**Note 6 -****Shareholders' Equity (continued)**Dividends and distributions

The following tables summarize the cash dividends/distributions payable to holders of common shares and holders of OP Units declared with respect to the nine months ended September 30, 2006 and the year ended December 31, 2005:

| HCP Shareholders                   |                             |                            |
|------------------------------------|-----------------------------|----------------------------|
| Dividend<br>per<br>Common<br>Share | Date<br>Dividend<br>Payable | Total<br>Amount<br>Payable |
| \$ 0.0589                          | 4/15/2005                   | \$ 412,931                 |
| 0.0589                             | 5/15/2005                   | 429,416                    |
| 0.0590                             | 6/15/2005                   | 439,453                    |
| 0.0589                             | 7/15/2005                   | 445,621                    |
| 0.0589                             | 8/15/2005                   | 452,396                    |
| 0.0590                             | 9/15/2005                   | 460,581                    |
| 0.0589                             | 10/15/2005                  | 467,260                    |
| 0.0589                             | 11/15/2005                  | 470,627                    |
| 0.0590                             | 12/15/2005                  | 480,737                    |
| 0.0589                             | 1/15/2006                   | 489,019                    |
| 0.0589                             | 2/15/2006                   | 509,475                    |
| 0.0590                             | 3/15/2006                   | 526,966                    |
| 0.0589                             | 4/15/2006                   | 535,420                    |
| 0.0589                             | 5/15/2006                   | 543,576                    |
| 0.0590                             | 6/15/2006                   | 552,430                    |
| 0.0500                             | 7/15/2006                   | 475,131                    |
| 0.0500                             | 8/15/2006                   | 481,585                    |
| 0.0500                             | 9/15/2006                   | 486,332                    |
| 0.0500                             | 10/15/2006                  | 489,344                    |
| 0.0500                             | 11/15/2006                  | 492,055                    |
| 0.0500                             | 12/15/2006                  | 495,995                    |



Hartman Commercial Properties REIT and Subsidiary  
Notes to Consolidated Financial Statements (Unaudited)  
September 30, 2006

**Note 6 -****Shareholders' Equity (continued)**

| OP Unit Holders Including<br>Minority Unit Holders |              |            |
|--|--------------|------------|
| Distribution                                       | Date         | Total      |
| per OP   | Distribution | Amount     |
| Unit   | Payable      | Payable    |
| \$ 0.0589  | 4/15/2005    | \$ 733,748 |
| 0.0589   | 5/15/2005    | 748,498    |
| 0.0590   | 6/15/2005    | 758,154    |
| 0.0589   | 7/15/2005    | 762,996    |
| 0.0589   | 8/15/2005    | 768,976    |
| 0.0590   | 9/15/2005    | 776,345    |
| 0.0589   | 10/15/2005   | 782,136    |
| 0.0589   | 11/15/2005   | 785,388    |
| 0.0590   | 12/15/2005   | 802,101    |
| 0.0589   | 1/15/2006    | 809,838    |
| 0.0589   | 2/15/2006    | 830,294    |
| 0.0590   | 3/15/2006    | 848,033    |
| 0.0589   | 4/15/2006    | 856,239    |
| 0.0589   | 5/15/2006    | 864,395    |
| 0.0590   | 6/15/2006    | 873,793    |
| 0.0500   | 7/15/2006    | 747,474    |
| 0.0500   | 8/15/2006    | 753,928    |
| 0.0500   | 9/15/2006    | 758,673    |
| 0.0500   | 10/15/2006   | 761,686    |
| 0.0500   | 11/15/2006   | 764,397    |
| 0.0500   | 12/15/2006   | 768,083    |

**Note 7 -****Commitments and Contingencies**

The Company is currently in litigation with Hartman Management and Allen R. Hartman concerning the validity of the amended and restated property management agreement and advisory agreement among other matters. The Company did not incur any material termination penalties as a result of the termination of the property management agreement or the original Property and Partnership Management Agreement. In addition, the Board elected not to renew the advisory agreement, the current payments under which had been extended on a month-to-month basis and ultimately expired on September 30, 2006. The previously mentioned litigation also contests the validity of the advisory agreement. The advisory agreement provided for the payment of a deferred performance fee, payable in certain events, including termination of the advisory agreement, based upon appreciation in the value of certain real

estate assets owned by the Company. The Company has not accrued any deferred performance fees, as it believes the amount of such fees, if any are owing, cannot be determined with reasonable certainty at this time.

The Company is a participant in various legal proceedings and claims that arise in the ordinary course of business. These matters are generally covered by insurance. While the resolution of these matters cannot be predicted with certainty, the Company believes that the final outcome of such matters will not have a material effect on the financial position, results of operations, or cash flows of the Company.

Hartman Commercial Properties REIT and Subsidiary  
Notes to Consolidated Financial Statements (Unaudited)  
September 30, 2006

**Note 8 -**

**Segment Information**

Management does not differentiate by property types and because no individual property is so significant as to be a separate segment, the Company does not present segment information.

**Note 9 -**

**Significant Events**

On October 2, 2006 the Board terminated the property management agreement with Hartman Management. The Board determined that it was in the best interests of the Company and its shareholders to terminate the property management agreement because of numerous unresolved issues and conflicts of interest between Allen R. Hartman, Hartman Management and the Company. In addition, the Board believed that it was in the best interests of the Company and its shareholders to move forward as a self-managed, self-administered REIT with a new, fully integrated management team. The Company is currently in litigation with Hartman Management and Allen R. Hartman concerning the validity of the property management agreement among other matters. The Company did not incur any material termination penalties as a result of the termination of the property management agreement. In addition, the Board elected not to renew the advisory agreement, the current payments under which had been extended on a month-to-month basis and ultimately expired on September 30, 2006. The previously mentioned litigation also contests the validity of the advisory agreement.

In addition, on October 2, 2006, the Board, at the unanimous recommendation of the independent Trustees, voted to remove Allen R. Hartman from his positions as Chief Executive Officer, Secretary and Chairman of the Board of the Company. On the same day, the Board appointed James C. Mastandrea, age 63, to serve as the Company's interim Chief Executive Officer and Chairman of the Board. Mr. Mastandrea has served as an independent member of the Company's Board since July 5, 2006, and is a member of the Investment Committee of the Board, which he chairs, and the newly formed Executive Committee of the Board of Trustees, which is comprised of Messrs. Vyas (Chair), Minton, Mahaffey and Mastandrea, and he will continue to serve as a member of the Board and the above mentioned committees with a term expiring, along with the other Trustees, at the Company's 2007 Annual Meeting of Shareholders. There are no arrangements or understandings between Mr. Mastandrea and any other person pursuant to which Mr. Mastandrea was selected as an officer. Since the beginning of the Company's last fiscal year, Mr. Mastandrea has had no direct or indirect interest in any transaction to which the Company was a party.

By letter dated October 27, 2006, Allen R. Hartman tendered his resignation as a member of the Board. Mr. Hartman's resignation is effective as of the date of the letter.

Mr. Hartman's resignation is a result of his disagreement with several of the Board's recent actions. On October 2, 2006, after Mr. Hartman declined to accept the Board's offer that Mr. Hartman voluntarily resign from his position with the Company, the Board voted to (i) remove Mr. Hartman from his positions as Chief Executive Officer, Secretary and Chairman of the Board of Trustees of the Company, (ii) terminate the property management agreement, and (iii) not renew the advisory agreement, the current payments under which had been extended on a month-to-month basis, ultimately expiring on September 30, 2006. Mr. Hartman is the sole limited partner of Hartman Management, as well as the president, secretary, sole trustee and sole shareholder of its general partner.

The Company is currently in litigation with Hartman Management and Mr. Hartman concerning termination of the Amended and Restated Management Agreement, among other matters.





Hartman Commercial Properties REIT and Subsidiary  
Notes to Consolidated Financial Statements (Unaudited)  
September 30, 2006

**Note 10 - Restatement of Prior Period Interim Financial Statements**

Due to restatements as described below and contained herein of the consolidated financial statements previously filed within Forms 10-Q for the quarterly periods ending March 31, 2006 and June 30, 2006, such financial statements contained therein should no longer be relied upon.

The Company determined that amortization expense reported on Form 10-Q for the three months ended March 31, 2006 and the six months ended June 30, 2006 did not reflect the write off of deferred lease commissions on a tenant that defaulted on its lease on March 28, 2006.

The following table reflects the adjusted data as of March 31, 2006 and June 30, 2006 and for the three months ended March 31, 2006 and the six months ended June 30, 2006:

|  | March 31, 2006                           |              |                            |
|--|--|--------------|----------------------------|
|  | As Previously<br>Reported<br>(Unaudited) | Adjustment   | As Restated<br>(Unaudited) |
| <b><u>Consolidated Balance Sheet</u></b>                       |  |              |                            |
| Deferred costs, net  | \$ 3,189,336                             | \$ (326,068) | \$ 2,863,268               |
| Total assets   | 171,372,946                              | (326,068)    | 171,046,878                |
| Minority Interests of unit holders in<br>Operating Partnership | 33,744,495                               | (127,500)    | 33,616,995                 |
| Total shareholders' equity                                     | 56,719,951                               | (198,568)    | 56,521,383                 |
| Total liabilities and shareholders' equity                     | \$ 171,372,946                           | \$ (326,068) | \$ 171,046,878             |

Three Months Ended March 31, 2006

|  | As Previously<br>Reported<br>(Unaudited) | Adjustment | As Restated<br>(Unaudited) |
|--|--|------------|----------------------------|
| <b><u>Consolidated Statement of Income</u></b> |  |            |                            |
| Amortization Expense                           | \$ 201,220                               | \$ 326,068 | \$ 527,288                 |
| Income before minority interests               | 1,262,710                                | (326,068)  | 936,642                    |
| Minority interests in Operating<br>Partnership | (499,335)                                | 127,500    | (371,835)                  |
| Net income                                     | 763,375                                  | (198,568)  | 564,807                    |
| Net income per common share                    | \$ 0.083                                 | \$ (0.022) | \$ 0.061                   |

Hartman Commercial Properties REIT and Subsidiary  
Notes to Consolidated Financial Statements (Unaudited)  
September 30, 2006

**Note 10 - Restatement of Prior Period Interim Financial Statements (Continued)**

June 30, 2006

|  | As Previously<br>Reported<br>(Unaudited) | Adjustment   | As Restated<br>(Unaudited) |
|--|--|--------------|----------------------------|
| <u>Consolidated Balance Sheet</u>                              |  |              |                            |
| Deferred costs, net  | \$ 3,332,060                             | \$ (326,068) | \$ 3,005,992               |
| Total assets   | 171,047,101                              | (326,068)    | 170,721,033                |
| Minority Interests of unit holders in<br>Operating Partnership | 33,417,786                               | (127,500)    | 33,290,286                 |
| Total shareholders' equity                                     | 59,344,700                               | (198,568)    | 59,146,132                 |
| Total liabilities and shareholders' equity                     | \$ 171,047,101                           | \$ (326,068) | \$ 170,721,033             |

Six Months Ended June 30, 2006

|  | As Previously<br>Reported<br>(Unaudited) | Adjustment | As Restated<br>(Unaudited) |
|--|--|------------|----------------------------|
| <u>Consolidated Statement of Income</u>        |  |            |                            |
| Amortization expense                           | \$ 409,147                               | \$ 326,068 | \$ 735,215                 |
| Income before minority interests               | 2,665,634                                | (326,068)  | 2,339,566                  |
| Minority interests in Operating<br>Partnership | (1,043,876)                              | 127,500    | (916,376)                  |
| Net income                                     | 1,621,758                                | (198,568)  | 1,423,190                  |
| Net income per common share                    | \$ 0.172                                 | \$ (0.021) | \$ 0.151                   |

## **Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operation**

You should read the following discussion of our financial condition and results of operations in conjunction with our financial statements and the notes thereto included in this report. For more detailed information regarding the basis of presentation for the following information, you should read the notes to the consolidated financial statements included in this report.

### ***Forward-Looking Statements***

This report on Form 10-Q includes "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Statements included in this quarterly report that are not historical facts (including any statements concerning plans and objectives of management for future operations or economic performance, or assumptions or forecasts related thereto), including, without limitation, the information set forth in this "Management's Discussion and Analysis of Financial Condition and Results of Operation," are forward-looking statements. These statements can be identified by the use of forward-looking terminology, including "forecast," "may," "believe," "will," "expect," "anticipate," "estimate," "continue" and similar words. These statements discuss future expectations, contain projections of results of operations or of financial condition or state other "forward-looking" information. We and our representatives may from time to time make other oral or written statements that are also forward-looking statements.

These forward-looking statements are made based upon management's current plans, expectations, estimates, assumptions and beliefs concerning future events impacting us and therefore involve a number of risks and uncertainties. While we believe that the assumptions concerning future events are reasonable, we caution that there are inherent difficulties in anticipating or predicting certain important factors. Such factors are discussed in our other filings, including but not limited to, our Annual Report on Form 10-K, filed with the Securities and Exchange Commission. We disclaim any intention or obligation to revise any forward-looking statements, including financial estimates, whether as a result of new information, future events or otherwise.

### ***Overview and Outlook***

We own 37 commercial properties, consisting of 19 retail centers, 12 office/warehouse properties and six office buildings. All of our properties are located in the Houston, Dallas and San Antonio, Texas metropolitan areas. As of September 30, 2006, we had 721 total tenants. No individual lease or tenant is material to our business. Revenues from our largest lease constituted 2.8% of our total revenues for the three months ended September 30, 2006. Leases for our properties range from one year for smaller spaces to over ten years for larger tenants. Our leases generally include minimum monthly lease payments and tenant reimbursements for payment of taxes, insurance and maintenance.

Historically our properties and day-to-day operations have been managed by Hartman Management. All property management and leasing personnel were employees of Hartman Management. Under the property management agreement previously in effect, we paid Hartman Management the following amounts:

- property management fees in an amount not to exceed the fees customarily charged in arm's length transactions by others rendering similar services in the same geographic area for similar properties as determined by a survey of brokers and agents in such area. These fees historically have ranged from two to four percent (2.0%-4.0%) of gross revenues for the management of commercial office buildings and approximately five percent (5.0%) of gross revenues for the management of retail and industrial properties.
-

for the leasing of the properties, a separate fee for the leases of new tenants and renewals of leases with existing tenants in an amount not to exceed the fee customarily charged in arm's length transactions by others rendering similar services in the same geographic area for similar properties as determined by a survey of brokers and agents in such area (with such fees, at present, being equal to 6% of the effective gross revenues from leases originated by Hartman Management and 4% of the effective gross revenues from expansions or renewals of existing leases).

- except as otherwise specifically provided, all costs and expenses incurred by Hartman Management in fulfilling its duties for the account of and on behalf of us. Such costs and expenses shall include the wages and salaries and other employee-related expenses of all on-site and off-site employees of Hartman Management who are engaged in the operation, management, maintenance or access control of our properties, including taxes, insurance and benefits relating to such employees, and legal, travel and other out-of-pocket expenses that are directly related to the management of specific properties.

Gross revenues are defined as all amounts actually collected as rents or other charges for the use and occupancy of our properties, but excludes interest and other investment income and proceeds received for a sale, exchange, condemnation, eminent domain taking, casualty or other disposition of assets.

In addition, Hartman Management managed our acquisition, disposition, financing, accounting and back-office operations under an advisory agreement effective September 1, 2004 through September 30, 2006. Under the advisory agreement, we paid Hartman Management for asset management services a quarterly fee in an amount equal to one-fourth of 0.25% of the gross asset value calculated on the last day of each preceding quarter. Under the advisory agreement, gross asset value is defined as the amount equal to the aggregate book value of our assets (other than investments in bank accounts, money market funds or other current assets), before depreciation, bad debts or other similar non-cash reserves and without reduction for any debt relating to such assets, at the date of measurement, except that during such periods in which we are obtaining regular independent valuations of the current value of our net assets for purposes of enabling fiduciaries of employee benefit plans to comply with applicable Department of Labor reporting requirements, gross asset value is the greater of (i) the amount determined pursuant to the foregoing or (ii) our assets' aggregate valuation established by the most recent such valuation report without reduction for depreciation, bad debts or other similar non-cash reserves and without reduction for any debt relating to such assets.

The aggregate fees and reimbursements payable to Hartman Management under the new agreements effective September 1, 2004 were not intended to be significantly different from those that would have been payable under the previous agreement. Upon actual calculation, the asset management fee under the new agreement was significantly higher. Hartman Management waived the excess of the fee for the period September 1, 2004 through March 31, 2006 in perpetuity. The asset management fee, as calculated under the new agreement, was charged by Hartman Management in the second and third quarters and has been reflected in the consolidated financial statements as of September 30, 2006.

The advisory agreement provided for the payment of a deferred performance fee, payable in certain events, including termination of the advisory agreement, based upon appreciation in the value of certain real estate assets owned by the Company. The advisory agreement expired by its terms on September 30, 2006, and on October 2, 2006, the Board elected not to renew the advisory agreement. We have not accrued any deferred performance fees, as we believe the amount of such fees, if any are owing, cannot be determined with reasonable certainty at this time. Hartman Management has asserted that approximately \$11 million is owed in deferred performance fees under the advisory agreement. Management believes that there is no reasonable basis for Hartman Management's assertion. To date, Hartman Management has made no demand for payment of the deferred performance fee under the advisory agreement. Management believes that Hartman Management will make such demand and could actually bring suit against us to collect such fee. Although we currently estimate that no deferred performance fee is owed, there can be no assurance that our view will ultimately prevail, and Hartman Management may successfully assert that a deferred performance fee is owed in an amount that would have a material adverse effect on our financial condition and results of operations.

The agreement with Hartman Management was terminated on October 2, 2006. We intend to operate as a self-managed, self-administered REIT in the future. As of November 9, 2006, we have hired 18 permanent employees, including vice presidents of leasing, property management and human resources, as well as managing directors of leasing, among other employees. We believe that our current staffing level is sufficient to effectively manage our property portfolio for the foreseeable future. As a self-managed REIT, we will bear our own expenses of operations, including the salaries, benefits and other compensation of our employees, office expenses, legal, accounting and investor relations expenses and other overhead, but will no longer pay management or advisory fees. In the short term, we believe expenses will be higher than normal due to litigation expenses associated with our efforts to gain control of

the Company's properties and business records. On a going-forward basis, we believe that our operations will be more efficient than they were when we were externally managed and our operating margins will improve as a result.

### ***Critical Accounting Policies***

Our discussion and analysis of our financial condition and results of operations are based on our consolidated financial statements. We prepared these financial statements in conformity with U.S. generally accepted accounting principles. The preparation of these financial statements required us to make estimates and assumptions that affect the reported amounts of assets and liabilities at the dates of the financial statements and the reported amounts of revenues and expenses during the reporting periods. We based our estimates on historical experience and on various other assumptions we believe to be reasonable under the circumstances. Our results may differ from these estimates. Currently, we believe that our accounting policies do not require us to make estimates using assumptions about matters that are highly uncertain. You should read Note 1, Summary of Significant Accounting Policies, to our financial statements in conjunction with this Management's Discussion and Analysis of Financial Condition and Results of Operations.

We have described below the critical accounting policies that we believe could impact our consolidated financial statements most significantly.

*Basis of Consolidation.* We are the sole general partner of Hartman REIT Operating Partnership, L.P. (the "Operating Partnership") and possess full legal control and authority over its operations. As of September 30, 2006 and December 31, 2005, we owned a majority of the partnership interests in the Operating Partnership ("OP Units"). Consequently, our consolidated financial statements include the accounts of the Operating Partnership. All significant intercompany balances have been eliminated. Minority interest in the accompanying consolidated financial statements represents the share of equity and earnings of the Operating Partnership allocable to holders of partnership interests other than us. Net income is allocated to minority interests based on the weighted-average percentage ownership of the Operating Partnership during the year. Issuance of additional common shares and OP Units changes our ownership interests as well as those of minority interests.

*Real Estate.* We record real estate properties at cost, net of accumulated depreciation. We capitalize improvements, major renovations and certain costs directly related to the acquisition, improvement and leasing of real estate. We charge expenditures for repairs and maintenance to operations as they are incurred. We calculate depreciation using the straight-line method over the estimated useful lives of 5 to 39 years of our buildings and improvements. We depreciate tenant improvements using the straight-line method over the life of the lease.

We review our properties for impairment whenever events or changes in circumstances indicate that the carrying amount of the assets, including accrued rental income, may not be recoverable through our operations. We determine whether an impairment in value has occurred by comparing the estimated future cash flows (undiscounted and without interest charges), including the estimated residual value of the property, with the carrying cost of the property. If impairment is indicated, we record a loss for the amount by which the carrying value of the property exceeds its fair value. We have determined that there has been no impairment in the carrying value of our real estate assets as of September 30, 2006 and December 31, 2005.

*Purchase Price Allocation.* We estimate the fair value of acquired tangible assets by valuing the acquired property as if it were vacant. The "as-if-vacant" value (limited to the purchase price) is allocated to land, building, and tenant improvements based on management's determination of the relative fair values of these assets. We record above-market and below-market in-place lease values for purchased properties based on the present value (using an interest rate which reflects the risks associated with the leases acquired) of the difference between (i) the contractual amounts to be paid pursuant to the in-place leases and (ii) management's estimate of fair market lease rates for the corresponding in-place leases, measured over a period equal to the remaining non-cancelable term of the lease. We amortize the capitalized above-market lease values as a reduction of rental income over the remaining non-cancelable terms of the respective leases. We amortize the capitalized below-market lease values as an increase to rental income over the initial term and any fixed-rate renewal periods in the respective leases. Because most of our leases are



relatively short term, have inflation or other scheduled rent escalations, and cover periods during which there have been few, and generally insignificant, pricing changes in the specific properties' markets, the properties we have acquired have not been subject to leases with terms materially different than then-existing market-level terms.

We measure the aggregate value of other intangible assets acquired based on the difference between (i) the property valued with existing in-place leases adjusted to market rental rates and (ii) the property valued as if vacant. Our management's estimates of value are made using methods similar to those used by independent appraisers, primarily discounted cash flow analysis. Factors considered by management in its analysis include an estimate of carrying costs during hypothetical expected lease-up periods considering current market conditions, and costs to execute similar leases. We also consider information obtained about each property as a result of our pre-acquisition due diligence, marketing and leasing activities in estimating the fair value of the tangible and intangible assets acquired. In estimating carrying costs, management will also include real estate taxes, insurance and other operating expenses and estimates of lost rentals at market rates during the expected lease-up periods, which we expect to primarily range from four to 18 months, depending on specific local market conditions. Our management also estimates costs to execute similar leases including leasing commissions, legal and other related expenses to the extent that such costs are not already incurred in connection with a new lease origination as part of the transaction.

The total amount of other intangible assets acquired is further allocated to in-place lease values and customer relationship intangible values based on our management's evaluation of the specific characteristics of each tenant's lease and our overall relationship with that respective tenant. Characteristics considered by our management in allocating these values include the nature and extent of our existing business relationships with the tenant, growth prospects for developing new business with the tenant, the tenant's credit quality and expectations of lease renewals (including those existing under the terms of the lease agreement), among other factors.

We amortize the value of in-place leases, if any, to expense over the remaining initial terms of the respective leases, which, for leases with allocated intangible value, we expect to range generally from five to 10 years. The value of customer relationship intangibles is amortized to expense over the remaining initial terms and any renewal periods in the respective leases, but in no event does the amortization period for intangible assets exceed the remaining depreciable life of the building. Should a tenant terminate its lease, the unamortized portion of the in-place lease value and customer relationship intangibles are charged to expense.

*Revenue Recognition.* All leases on properties we hold are classified as operating leases, and we recognize the related rental income on a straight-line basis over the terms of the related leases. We capitalize or charge to accrued rent receivable, as applicable, differences between rental income earned and amounts due per the respective lease agreements. Percentage rents are recognized as rental income when the thresholds upon which they are based have been met. Recoveries from tenants for taxes, insurance, and other operating expenses are recognized as revenues in the period the corresponding costs are incurred. We provide an allowance for doubtful accounts against the portion of tenant accounts receivable which we estimate to be uncollectible.

*Restatement.* Subsequent to September 30, 2006, but before the completion of the review for the quarter ended September 30, 2006, management determined that deferred commissions related to an early lease termination on March 28, 2006 were not charged to operations. In accordance with Company policy, deferred lease commissions for tenants that pre-maturely vacate a lease are to be charged to amortization expense in the period in which the default occurs. Accordingly, the Consolidated Balance Sheets as of March 31, 2006 and June 30, 2006 and the Consolidated Statements of Operations for the three months ended March 31, 2006 and the six months ended June 30, 2006 have been restated. See Note 10.

### ***Liquidity and Capital Resources***

*General.* We generally lease our properties on a triple-net basis or on bases which provide for tenants to pay for increases in operating expenses over a base year or set amount, which means that tenants are required to pay for all repairs and maintenance, property taxes, insurance and utilities, or increases thereof, applicable to their space. During the nine months ended September 30, 2006, our cash flows provided from operating activities were \$11.2 million and

we paid total distributions of approximately \$7.5 million. Therefore, we had excess cash flow of approximately \$3.7 million. At times we have partially funded our distributions to shareholders out of our lines of credit. To the extent a portion of the net offering proceeds have been utilized to repay amounts borrowed under our lines of credit, such net offering proceeds may be regarded as being distributions to shareholders, all or a portion of which may be characterized as a return of capital.

We anticipate that cash flows from operating activities and our borrowing capacity will allow us to make all distributions required for us to continue to qualify to be taxed as a REIT.

*Public Offering.* As reflected in Note 6 to the consolidated financial statements, on September 15, 2004, our Registration Statement on Form S-11 with respect to our ongoing, best efforts public offering of up to 10,000,000 common shares of beneficial interest at a price of \$10.00 per share was declared effective under the Securities Act of 1933. The Registration Statement also covers up to 1,000,000 shares available pursuant to our dividend reinvestment plan to be offered at a price of \$9.50 per share. The shares are offered to investors on a best efforts basis. As of September 30, 2006, 2,886,405 shares had been issued pursuant to the Public Offering with net offering proceeds received of \$25,235,047. For a more detailed discussion of the results of the Public Offering through the end of the third quarter and our application of the offering proceeds through such date, see Part II, Item 2 of this report. The Board suspended the Public Offering effective October 2, 2006.

*Cash and Cash Equivalents.* We had cash and cash equivalents of \$4,421,731 on September 30, 2006 as compared to \$848,998 on December 31, 2005. The increase was principally due to release of approximately \$3.2 million in escrows required by the debt with GMAC Commercial Mortgage Corporation which was paid in full on September 30, 2006. We generally do not maintain large cash balances, but rather utilize cash on hand for one of the foregoing purposes or for making distributions to shareholders. We place all cash in short-term, highly liquid investments that we believe provide appropriate safety of principal.

*Our Debt for Borrowed Money.* On June 30, 2003, the Company entered into a \$25,000,000 loan agreement with a bank pursuant to which the Company could, subject to the satisfaction of certain conditions, borrow funds to acquire additional income producing properties. The revolving loan agreement matured in June, 2005 and provided for interest payments at a rate, adjusted monthly, of either (at the Company’s option) 30-day LIBOR plus 225 basis points, or the bank’s prime rate less 50 basis points, with either rate subject to a floor of 3.75% per annum. The loan was secured by then owned and otherwise unencumbered properties and could also be secured by properties acquired with the proceeds drawn from the facility. The Company was required to make monthly payments of interest only, with the principal and all accrued unpaid interest being due at maturity of the loan. The loan could be prepaid at any time without penalty. The Company paid off and closed this credit facility during June 2005.

The Company has a revolving credit facility with a consortium of banks. The credit facility is secured by a pledge of the partnership interests in Hartman REIT Operating Partnership III LP (“HROP III”), a wholly owned subsidiary of the Operating Partnership that was formed to hold title to the properties comprising the borrowing base pool for the facility. At that time, there were 18 properties owned by HROP III.

The original limit of the credit facility was \$50,000,000 and it may be increased to \$100,000,000 as the borrowing base pool expands. The Company entered into this credit facility to refinance its then existing loan described above, to finance property acquisitions and for general corporate purposes.

On May 31, 2006, pursuant to section 2.8 of the Revolving Credit Agreement, dated as of March 11, 2005, the Company requested to increase the limit of the credit facility by \$25,000,000, so that the total credit facility will be \$75,000,000.

On June 26, 2006, the Company conveyed ownership of 18 properties from Hartman REIT Operating Partnership II LP (“HROP II”) to HROP III in order to expand the borrowing base pool for the credit facility. At September 30, 2006, 36 properties are owned by HROP III.

On June 30, 2006, the Company drew down \$34,750,000 on the line of credit to extinguish the three year floating rate mortgage loan described below and pay related legal and banking fees.

As of September 30, 2006 and December 31, 2005 the balance outstanding under the facility was \$61,225,094 and \$32,975,094, respectively and the availability to draw was \$13,774,906 and \$17,024,906, respectively.

Outstanding amounts under the facility will accrue interest, at the Company’s option, at either the LIBOR Rate or the Alternative Base Rate, plus the applicable margin as determined from the following grid:

| Total Leverage Ratio | LIBOR Margin | Alternative Base Rate Margin |
|----------------------|--------------|------------------------------|
|----------------------|--------------|------------------------------|

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|  |       |        |
|--|-------|--------|
| Less than 60% but greater than or equal to 50% | 2.40% | 1.150% |
| Less than 50% but greater than or equal to 45% | 2.15% | 1.025% |
| Less than 45%                                  | 1.90% | 1.000% |

The Alternative Base Rate equals a floating rate equal to the higher of KeyBank's Base Rate or Federal Funds Rate plus 0.5%. Interest is due monthly in arrears, computed on the actual number of days elapsed over a 360-day year. LIBOR Rate loans will be available in one, two, three or nine month periods, with a maximum of nine contracts at any time. In the event of default, interest will be calculated as above plus 2%. The effective interest rate as of September 30, 2006 was 7.22% per annum.

Interest only is payable monthly under the loan with the total amount of principal due at maturity on March 11, 2008. The loan may be prepaid at any time in part or in whole, provided that the facility is not in default. If LIBOR Rate pricing is elected, there is a prepayment penalty based on a "make-whole" calculation for all costs associated with prepaying a LIBOR borrowing.

The revolving line of credit is supported by a pool of eligible properties referred to as the borrowing base pool. The borrowing base pool must meet the following criteria:

- The Company will provide a negative pledge on the borrowing base pool and may not provide a negative pledge of the borrowing base pool to any other lender.

- The properties must be free of all liens, unless otherwise permitted.

- All eligible properties must be retail, office-warehouse, or office properties, must be free and clear of material environmental concerns and must be in good repair.

- The aggregate physical occupancy of the borrowing base pool must remain above 80% at all times.

- No property may comprise more than 15% of the value of the borrowing base pool with the exception of Corporate Park Northwest, which is allowed into the borrowing base pool.

- The borrowing base pool must at all times be comprised of at least 10 properties.

- The borrowing base pool properties may not contain development or redevelopment projects.

Properties can be added to and removed from the borrowing base pool at any time provided no defaults would occur as a result of the removal. If a property does not meet the criteria of an eligible property and the Company wants to include it in the borrowing base pool, a majority vote of the bank consortium is required for inclusion in the borrowing base pool.

Covenants, tested quarterly, relative to the borrowing base pool are as follows:

- The Company will not permit any liens on the properties in the borrowing base pool unless otherwise permitted.

- The ratio of aggregate net operating income from the borrowing base pool to debt service shall at all times exceed 1.5 to 1.0. For any quarter, debt service shall be equal to the average loan balance for the past quarter times an interest rate which is the greater of (a) the then current annual yield on 10 year United States Treasury notes over 25 years plus 2%; (b) a 6.5% constant; or (c) the actual interest rate for the facility.

The ratio of the value of the borrowing base pool to total funded loan balance must always exceed 1.67 to 1.00. The value of the borrowing base pool is defined as aggregate net operating income for the preceding four quarters, less a \$0.15 per square foot per annum capital expenditure reserve, divided by a 9.25% capitalization rate.

Covenants, tested quarterly, relative to the Company are as follows:

·The Company will not permit its total indebtedness to exceed 60% of the fair market value of its real estate assets at the end of any quarter. Total indebtedness is defined as all liabilities of the Company, including this facility and all other secured and unsecured debt of the Company, including letters of credit and guarantees. Fair market value of real estate assets is defined as aggregate net operating income for the preceding four quarters, less a \$0.15 per square foot per annum capital expenditure reserve, divided by a 9.25% capitalization rate.

- The ratio of consolidated rolling four-quarter earnings before interest, income tax, depreciation and amortization expenses for such quarter to total interest expense, including capitalized interest, shall not be less than 2.0 to 1.0.
- The ratio of consolidated earnings before interest, income tax, depreciation and amortization expenses for such quarter to total interest, including capitalized interest, principal amortization, capital expenditures and preferred stock dividends shall not be less than 1.5 to 1.0. Capital expenditures shall be deemed to be \$0.15 per square foot per annum.
  - The ratio of secured debt to fair market value of real estate assets shall not be greater than 40%.
    - The ratio of declared dividends to funds from operations shall not be greater than 95%.
  - The ratio of development assets to fair market value of real estate assets shall not be greater than 20%.
  - The Company must maintain its status as a real estate investment trust for income tax purposes.
- Total other investments shall not exceed 30% of total asset value. Other investments shall include investments in joint ventures, unimproved land, marketable securities and mortgage notes receivable. Additionally, the preceding investment categories shall not comprise greater than 30%, 15%, 10% and 20%, respectively, of total other investments.

The Company must hedge all variable rate debt above \$40 million until the point in which the ratio of variable rate debt to fixed rate debt is 50% of total debt and maintain such hedges during any period in which variable rate debt exceeds 50% of total debt. On March 27, 2006, the Company executed an interest rate swap dated as of March 16, 2006 for the purpose of hedging variable interest rate exposure, in compliance with the requirements of the loan agreement. The lender waived default for the fact that the hedge was not executed within nine months of closing, as required by the loan agreement.

As of December 31, 2005, the Company was in violation of a loan covenant which provides that the ratio of declared dividends to funds from operations (as defined in the loan agreement) shall not be greater than 95%. As this violation constitutes an event of default, the lenders had the right to accelerate payment of this credit facility. However, on May 8, 2006 the Company received a waiver from the required majority of the consortium banks in the credit facility and also entered into a modification of the loan agreement whereby the covenant was amended through December 31, 2006. As amended, the ratio of declared dividends to funds from operations (as defined in the loan agreement) shall not exceed 107% for the three months ended March 31, 2006 and June 30, 2006, 104% for the three months ended September 30, 2006 and 100% for the three months ended December 31, 2006. The Company is now in compliance with the covenant, as amended.

On October 2, 2006, the Company's Board of Trustees (i) elected not to renew an advisory agreement between the Company and Hartman Management pursuant to which Hartman Management had previously managed, among other things, the Company's acquisition and disposition programs, financing activities and accounting and back-office operations; (ii) provided verbal notice, followed by written notice, that it was terminating the property management agreement between the Company and Hartman Management pursuant to which Hartman Management had historically managed the leasing and operation of the Company's real properties; and (iii) removed Allen R. Hartman, who is the chief executive officer and sole owner of Hartman Management, from his positions as chairman, president, secretary and chief executive officer of the Company. These actions violated certain covenants in the loan agreement and were events of default thereunder. On October 31, 2006, the Company gave written notice to its lenders of the foregoing events of default and requested that the lenders waive such defaults. On November 9, 2006, the lenders granted a



temporary waiver of such events of default until February 1, 2007, which waiver will become permanent at such time so long as (1) the Company timely delivers to the lenders all financial statements, certificates and other financial information required by the loan agreement, and (2) KeyBank, as agent for the lenders, is satisfied with the Company's ability to manage its real estate portfolio without the benefit of an external property manager.

In December 2002, we refinanced most of our debt with a credit facility from GMAC Commercial Mortgage Corporation. The loan is secured by, among other things, 18 of our properties, which are held by HROP II, a wholly-owned subsidiary formed for the purpose of this credit facility, and the improvements, personal property and fixtures on the properties, all reserves, escrows and deposit accounts held by HROP II, all intangible assets specific to or used in connection with the properties, and an assignment of rents related to such properties. We believe the fair market value of these properties was approximately \$62,000,000 at the time the loan was put in place. We may prepay the loan without penalty. This loan was paid in full on June 30, 2006.

In connection with the purchase of the Windsor Park property in December 2003, we assumed a note payable in the amount of \$6,550,000 secured by the property. The balance at September 30, 2006 was \$5,226,826. The note is payable in equal monthly installments of principal and interest of \$80,445, with interest at the rate of 8.34% per annum. The balance of the note is payable in full on December 1, 2006. The Company is in process of requesting an extension of the December 1, 2006 maturity date and obtaining new financing to pay off the note.

*Capital Expenditures.* We are currently reviewing all properties to determine the amount of capital expenditures and improvements during the next 12 months. We may also have unexpected capital expenditures or improvements on our existing assets. Additionally, we intend to continue our ongoing acquisition strategy of acquiring properties (generally in the \$1,000,000 to \$10,000,000 value range) in the Houston and Dallas, Texas metropolitan areas, with similar market characteristics, where we believe opportunities exist for acceptable investment returns, and we may incur significant capital expenditures or make significant improvements in connection with any properties we may acquire.

*Total Contractual Cash Obligations.* A summary of our contractual cash obligations, as of September 30, 2006 is as follows:

| Contractual Obligations  | Total         | Payment due by period |                    |                     |                      |
|--|---------------|-----------------------|--------------------|---------------------|----------------------|
|  |               | Less than One Year    | One to Three Years | Three to Five Years | More than Five Years |
| Long-Term Debt Obligations   | \$ 66,601,238 | \$ 5,376,144          | \$ 61,225,094      | \$ -                | \$ -                 |
| Capital Lease Obligations  | -             | -                     | -                  | -                   | -                    |
| Operating Lease Obligations  | -             | -                     | -                  | -                   | -                    |
| Purchase Obligations   | -             | -                     | -                  | -                   | -                    |
| Other Long-Term Liabilities Reflected on the Registrant's Balance Sheet under GAAP | -             | -                     | -                  | -                   | -                    |
| Total  | \$ 66,601,238 | \$ 5,376,144          | \$ 61,225,094      | \$ -                | \$ -                 |

We have no commercial commitments such as lines of credit or guarantees that might result from a contingent event that would require our performance pursuant to a funding commitment.

*Property Acquisitions.* During 2005, we acquired from unrelated parties three multi-tenant office buildings comprising approximately 486,024 square feet of gross leasable area (GLA). The properties were acquired for cash in the amount

of approximately \$30,430,000. No properties have been acquired during the nine months ended September 30, 2006.

*Common Share Dividends.* We declared the following dividends to our shareholders with respect to the first quarter of 2005 through the third quarter of 2006, payable in three monthly installments after the end of each respective quarter:

| <b>HCP Shareholders</b> |                |                 |
|-------------------------|----------------|-----------------|
| <b>Date</b>             | <b>Total</b>   |                 |
| <b>Dividend</b>         | <b>Amount</b>  | <b>Dividend</b> |
| <b>Payable</b>          | <b>Payable</b> | <b>per</b>      |
|                         |                | <b>Common</b>   |
|                         |                | <b>Share</b>    |
| 4/15/2005               | \$ 412,931     | \$ 0.0589       |
| 5/15/2005               | 429,416        | 0.0589          |
| 6/15/2005               | 439,453        | 0.0590          |
| 7/15/2005               | 445,621        | 0.0589          |
| 8/15/2005               | 452,396        | 0.0589          |
| 9/15/2005               | 460,581        | 0.0590          |
| 10/15/2005              | 467,260        | 0.0589          |
| 11/15/2005              | 470,627        | 0.0589          |
| 12/15/2005              | 480,737        | 0.0590          |
| 1/15/2006               | 489,019        | 0.0589          |
| 2/15/2006               | 509,475        | 0.0589          |
| 3/15/2006               | 526,966        | 0.0590          |
| 4/15/2006               | 535,420        | 0.0589          |
| 5/15/2006               | 543,576        | 0.0589          |
| 6/15/2006               | 552,430        | 0.0590          |
| 7/15/2006               | 475,131        | 0.0500          |
| 8/15/2006               | 481,585        | 0.0500          |
| 9/15/2006               | 486,332        | 0.0500          |
| 10/15/2006              | 489,344        | 0.0500          |
| 11/15/2006              | 492,055        | 0.0500          |
| 12/15/2006              | 495,995        | 0.0500          |
| <b>Average Per</b>      |                |                 |
| <b>Quarter</b>          |                | \$ 0.1691       |



*OP Unit Distributions.* The Operating Partnership declared the following distributions to holders of its OP Units, including the Company, with respect to the first quarter of 2005 through the third quarter of 2006, payable in three monthly installments after the end of each respective quarter:

**OP Unit Holders Including Minority  
Unit Holders**

| <b>Date</b>                | <b>Total</b>   |                     |
|----------------------------|----------------|---------------------|
| <b>Distribution</b>        | <b>Amount</b>  | <b>Distribution</b> |
| <b>Payable</b>             | <b>Payable</b> | <b>per OP Unit</b>  |
| 4/15/2005                  | \$ 733,748     | \$ 0.0589           |
| 5/15/2005                  | 748,498        | 0.0589              |
| 6/15/2005                  | 758,154        | 0.0590              |
| 7/15/2005                  | 762,996        | 0.0589              |
| 8/15/2005                  | 768,976        | 0.0589              |
| 9/15/2005                  | 776,345        | 0.0590              |
| 10/15/2005                 | 782,136        | 0.0589              |
| 11/15/2005                 | 785,388        | 0.0589              |
| 12/15/2005                 | 802,101        | 0.0590              |
| 1/15/2006                  | 809,838        | 0.0589              |
| 2/15/2006                  | 830,294        | 0.0589              |
| 3/15/2006                  | 848,033        | 0.0590              |
| 4/15/2006                  | 856,239        | 0.0589              |
| 5/15/2006                  | 864,395        | 0.0589              |
| 6/15/2006                  | 873,793        | 0.0590              |
| 7/15/2006                  | 747,474        | 0.0500              |
| 8/15/2006                  | 753,928        | 0.0500              |
| 9/15/2006                  | 758,674        | 0.0500              |
| 10/15/2006                 | 761,686        | 0.0500              |
| 11/15/2006                 | 764,397        | 0.0500              |
| 12/15/2006                 | 768,083        | 0.0500              |
| <b>Average Per Quarter</b> | <b>\$</b>      | <b>0.1691</b>       |



**Results of Operations****Comparison of the Nine Month Periods Ended September 30, 2006 and 2005***General.*

The following tables provide a general comparison of our results of operations for the nine months ended September 30, 2006 and 2005:

|   | Nine Months Ended September 30, |               |
|---|---------------------------------|---------------|
|   | 2006                            | 2005          |
| Total revenues                                  | \$ 22,763,664                   | \$ 18,787,678 |
| Total expenses                                  | 19,450,507                      | 15,031,956    |
| Income before minority interests                | 3,313,157                       | 3,755,722     |
| Minority interests in the Operating Partnership | (1,287,552)                     | (1,669,492)   |
| Net income                                      | \$ 2,025,605                    | \$ 2,086,230  |

|   | September 30, |           |
|---|---------------|-----------|
|   | 2006          | 2005      |
| Number of properties owned and operated | 37            | 36        |
| Aggregate gross leasable area (sq. ft.) | 3,121,037     | 2,687,000 |
| Occupancy rate                          | 83%           | 85%       |

*Revenues.*

Rental income, tenant reimbursements and other income was \$22,763,664 for the nine months ended September 30, 2006 as compared to revenues of \$18,787,678 for the nine months ended September 30, 2005. This represents an increase of 21%. Substantially all of our revenues are derived from rents received from the use of our properties. The increase in our revenues during the nine months ended September 30, 2006 over the same period in 2005 was due to an increase in the amount of rent charged at some locations and the purchase of additional properties. Our occupancy rate at September 30, 2006 was 83%, as compared to 85% at September 30, 2005. Our average annualized revenue per square foot was \$9.54 and \$9.15 for the nine months ended September 30, 2006 and 2005, respectively.

Interest and other income was \$589,196 for the nine months ended September 30, 2006 as compared to \$398,258, for the nine months ended September 30, 2005, an increase of \$190,938. We hold all revenues and proceeds we receive from offerings and loans in money market accounts and other short-term, highly liquid investments. The primary reason for the increase for the nine months ended September 30, 2006 was increased interest income as a result of higher cash balances.

*Expenses.*

Our total expenses, including interest expense and depreciation and amortization expense were \$19,450,507 for the nine months ended September 30, 2006 as compared to \$15,031,956 for the nine months ended September 30, 2005. This is an increase of \$4,418,551 or 29%.



We expect that the dollar amount of operating expenses will increase as we acquire additional properties and expand our operations.

The increase in our operating expenses during the nine months ended September 30, 2006 was primarily the result of increased operating and maintenance, real estate taxes, utilities and depreciation primarily due to new property acquisitions, and interest due to higher debt levels as a result of new property acquisitions and interest rate increases.

The amount we pay Hartman Management under our property management agreement is based in part on our property revenues. As a result of our increased revenues in the nine months ended September 30, 2006 due to increased rent rate and the addition of new properties and a property management increase in several properties that was retroactive to January 1, 2006, management fees were \$1,359,903 and \$1,052,679 for the nine months ended September 30, 2006 and 2005, respectively.

Our interest expense increased by \$1,287,300 or 49%, for the nine months ended September 30, 2006 over the nine months ended September 30, 2005. Our average outstanding debt was \$70,950,470 for the nine months ended September 30, 2006 as compared to \$60,373,396 for the nine months ended September 30, 2005. Our average interest rate associated with this debt increased to 7.4% for the nine months ended September 30, 2006 as compared to 5.74% for the nine months ended September 30, 2005. In March 2006, we executed an interest rate swap to hedge \$30,000,000 of our variable-rate debt against future increases in interest rates, although the interest rate of the swap agreement has not reduced our interest expense during 2006.

#### *Net Income.*

Income provided by operating activities before minority interests was \$3,313,157 and \$3,755,722 for the nine months ended September 30, 2006 and 2005, respectively. Net income was \$2,025,605 and \$2,086,230 for the nine months ended September 30, 2006 and 2005, respectively. The decrease in net income was the result of the items discussed above in expenses and revenue.

#### **Comparison of the Three Month Periods Ended September 30, 2006 and 2005**

##### *General.*

The following tables provide a general comparison of our results of operations for the three months ended September 30, 2006 and 2005:

|   | Three Months Ended September 30, |              |
|---|----------------------------------|--------------|
|   | 2006                             | 2005         |
| Total revenues                                  | \$ 7,476,443                     | \$ 6,204,629 |
| Total expenses                                  | 6,502,853                        | 5,310,457    |
| Income before minority interests                | 973,590                          | 894,172      |
| Minority interests in the Operating Partnership | (371,176)                        | (382,662)    |
| Net income                                      | \$ 602,414                       | \$ 511,510   |

|   | September 30, |           |
|---|---------------|-----------|
|   | 2006          | 2005      |
| Number of properties owned and operated | 37            | 36        |
| Aggregate gross leasable area (sq. ft.) | 3,121,037     | 2,687,000 |
| Occupancy rate                          | 83%           | 85%       |

##### *Revenues.*

Rental income, tenant reimbursements and other income was \$7,476,443 and \$6,204,629 for the three months ended September 30, 2006 and 2005, respectively. This is an increase of \$1,271,814, or 21%. Substantially all of our revenues are derived from rents received from the use of our properties. The increase in our revenues during the three months ended September 30, 2006 over the same period in 2005 was due to an increase in the amount of rent charged at some locations and the purchase of additional properties. Our occupancy rate at September 30, 2006 was 83%, as compared to 85% at September 30, 2005. Our average annualized revenue was \$9.80 and \$8.82 per square foot for the three months ended September 30, 2006 and 2005, respectively.

Interest and other income was \$35,641 and \$181,739 for the three months ended September 30, 2006 and 2005, respectively. This represents a decrease of \$146,098 or 80%. The primary reason for the decrease in the three months ended September 30, 2006 was a decrease in the value of the interest rate swap of \$199,000.

*Expenses.*

Our total expenses, including interest expense and depreciation and amortization expense were \$6,502,853 and \$5,310,457 for the three months ended September 30, 2006 and 2005, respectively. This represents an increase of \$1,192,396 or 22%.

We expect that the dollar amount of operating expenses will increase as we acquire additional properties and expand our operations.

The increase in our operating expenses during the three months ended September 30, 2006 was primarily the result of increased interest expense, depreciation and amortization, real estate taxes, utilities and management fees paid to Hartman Management. The increases to depreciation, real estate taxes and utilities are primarily due to new property acquisitions. The increase to interest expense is due to higher debt and interest rate increases.

The amount we pay Hartman Management under our property management agreement is based in part on our property revenues. As a result of our increased revenues in the three months ended September 30, 2006 due to increased rent rate and the addition of new properties and a property management increase in several properties that was retroactive to January 1, 2006, management fees were \$556,283 and \$323,517 for the three months ended September 30, 2006 and 2005, respectively.

Our interest expense increased by \$258,615, or 27% for the three months ended September 30, 2006 as compared to the three months ended September 30, 2005. Our average outstanding debt was \$68,729,821 and \$60,588,693 for the three months ended September 30, 2006 and 2005, respectively. Our average interest rate associated with this debt increased to 7.2% for the three months ended September 30, 2006 as compared to 6.4% for the three months ended September 30, 2005. In March 2006, we executed an interest rate swap to hedge \$30,000,000 of our variable-rate debt against future increases in interest rates, although the interest rate of the swap agreement has not reduced our interest expense during 2006.

*Net Income.*

Income provided by operating activities before minority interests was \$973,590 and \$894,172 for the three months ended September 30, 2006 and 2005, respectively. Net income was \$602,414 and \$511,510 for the three months ended September 30, 2006 and 2005, respectively. The increase in net income was the result of the items discussed above in expenses and revenue.

*Taxes*

We elected to be taxed as a REIT under the Internal Revenue Code beginning with our taxable year ended December 31, 1999. As a REIT, we generally are not subject to federal income tax on income that we distribute to our shareholders. If we fail to qualify as a REIT in any taxable year, we will be subject to federal income tax on our taxable income at regular corporate rates. We believe that we are organized and operate in such a manner as to qualify to be taxed as a REIT, and we intend to operate so as to remain qualified as a REIT for federal income tax purposes.

*Inflation*

We anticipate that our leases will continue to be triple-net leases or otherwise provide that tenants pay for increases in operating expenses and will contain provisions that we believe will mitigate the effect of inflation. In addition, many of our leases are for terms of less than five years, which allows us to adjust rental rates to reflect inflation and other changing market conditions when the leases expire. Consequently, increases due to inflation, as well as ad valorem tax rate increases, generally do not have a significant adverse effect upon our operating results.

***Environmental Matters***

Our properties are subject to environmental laws and regulations adopted by various governmental authorities in the jurisdictions in which our operations are conducted. From our inception, we have incurred no significant environmental costs, accrued liabilities or expenditures to mitigate or eliminate future environmental contamination.

***Off-Balance Sheet Arrangements***

We have no significant off-balance sheet arrangements as of September 30, 2006 and December 31, 2005.

### **Item 3. Quantitative and Qualitative Disclosures About Market Risk**

Market risk is the risk of loss arising from adverse changes in market rates and prices. The principal market risk to which we are exposed is the risk related to interest rate fluctuations. Based upon the nature of our operations, we are not subject to foreign exchange or commodity risk. We will be exposed to changes in interest rates as a result of our credit facilities which have floating interest rates. As of September 30, 2006, we had \$61,225,000 of indebtedness outstanding under these facilities, \$31,225,000 of which was not hedged to protect against rising interest rates. The impact of a 1% increase in interest rates on our debt would result in an increase in interest expense and a decrease in income before minority interests of approximately \$312,250.

### **Item 4. Controls and Procedures**

#### *Evaluation of Disclosure Controls and Procedures*

As of the end of the period covered by this report, the Company carried out an evaluation, under the supervision and with the participation of the Company's management, of the effectiveness of the design and operation of the Company's disclosure controls and procedures, as defined in Exchange Act Rule 13a-15(e) and 15d-15(e).

As reported in our annual report on Form 10-K for the year ended December 31, 2005, our independent registered public accounting firm, in the course of the audit of our 2005 financial statements, brought to management's attention two material weaknesses in our internal controls: (1) Inadequate controls and procedures in place to effectively identify and monitor amendments to lease agreements and (2) Inadequate controls and procedures in place to effectively identify and monitor tenant defaults where a lease commission has been recorded. As a result of these deficiencies, our accounting personnel may not be made aware of changes to lease agreements and tenant defaults that require recognition in our financial accounting records. Accordingly, errors in our accounting for revenue and amortization expense may occur and may not be detected. A material weakness (within the meaning of the Public Company Accounting Oversight Board Auditing Standard No. 2) is a control deficiency, or aggregation of control deficiencies, that result in more than a remote risk that a material misstatement in the Company's annual or interim financial statements will not be prevented or detected.

In the current quarter it was discovered by the Company that amortization expense had not been recorded properly for the three months ended March 31, 2006 and the six months ended June 30, 2006. This was the result of deferred lease commission not being written off on a tenant that defaulted on their lease on March 28, 2006. The impact of this adjustment on prior quarter's financial statements is detailed in Note 10 to the Consolidated financial statements.

Based upon managements evaluation for the year ended December 31, 2005 and the material weaknesses described in the preceding paragraph, the Company's Chief Executive Officer and the Chief Financial Officer have concluded that the Company's disclosure controls and procedures are not effective in timely alerting them to material information relating to the Company (including its consolidated subsidiaries) that is required to be included in the Company's Exchange Act filings. The Company is in the process of remediating the material weaknesses and intends to engage an external consultant to assist management in establishing and maintaining adequate controls and remediating the identified material.

#### *Changes in Internal Control over Financial Reporting*

There were no changes in the Company's internal controls over financial reporting that occurred during the three months ended September 30, 2006 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.





## **PART II. OTHER INFORMATION**

### **Item 1. Legal Proceedings**

The Company is currently in litigation with Hartman Management and Allen R. Hartman concerning the validity of the amended and restated management agreement among other matters. The Company did not incur any material termination penalties as a result of the termination of the amended and restated property management agreement or the original property and partnership management agreement. In addition, the Board elected not to renew an advisory agreement, dated as of August 31, 2004, between the Company and Hartman Management, the current payments under which had been extended on a month-to-month basis and ultimately expired on September 30, 2006. The previously mentioned litigation also contests the validity of the advisory agreement.

From time to time, we are subject to certain legal proceedings claims and disputes that arise in the ordinary course of our business. Although we cannot predict the outcomes of these legal proceedings, we do not believe these actions, in the aggregate, will have a material adverse impact on our financial position, results of operations or liquidity.

### **Item 1A. Risk Factors**

The discussion of the Company's business and operations should be read together with the risk factors contained in Item 1A of the Company's Annual Report on Form 10-K for the year ended December 31, 2005, filed with the Securities and Exchange Commission, which describe various risks and uncertainties to which we are or may become subject. These risks and uncertainties have the potential to affect the Company's business, financial condition, results of operations, cash flows, strategies or prospects in a material and adverse manner. As of September 30, 2006, there have been no material changes to the risk factors set forth in the Company's Annual Report on Form 10-K for the year ended December 31, 2005.

### **Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

The Company's Registration Statement on Form S-11 (SEC File No. 333-111674) was declared effective by the SEC on September 15, 2004 with respect to the ongoing Public Offering described in Note 6 to the Consolidated Financial Statements included in Item 1 of this Report, of up to 10,000,000 shares of the Company's common stock to the public at a price of \$10 per share, plus up to 1,000,000 shares available for sale pursuant to our dividend reinvestment plan, to be offered at a price of \$9.50 per share, and the Company commenced the Public Offering on such date. Post-Effective Amendments No. 1, 2 and 3 to the Registration Statement were declared effective by the SEC on June 27, 2005, March 9, 2006 and May 3, 2006, respectively.

The 10,000,000 shares offered to the public in the Public Offering were being offered to investors on a best efforts basis by the dealer manager D.H. Hill Securities, LLP, which means that the broker-dealers participating in the offering are only required to use their best efforts to sell the shares and have no firm commitment or obligation to purchase any of the shares.

As of September 30, 2006, an aggregate of 2,886,405 shares had been issued pursuant to the Public Offering with gross offering proceeds received of \$28,859,004. The Company's application of such gross offering proceeds through September 30, 2006 was as follows:

| Description of Use of Offering Proceeds | Amount of<br>Proceeds so<br>Utilized |
|---|--------------------------------------|
|   |                                      |

|   |                   |
|---|-------------------|
| Selling Commissions paid to broker/ dealers not affiliated with<br>D.H. Hill Securities , LLP | \$ 1,609,632      |
| Selling Discounts   | 70,365            |
| Dealer Manager Fee paid to D.H. Hill Securities , LLP   | 692,369           |
| Offering expense reimbursements paid to the Management Company                                | 695,328           |
| Acquisition Fees paid to the Management Company   | 556,263           |
| Total Offering Expenses   | \$ 3,623,957      |
| <br>Net Offering Proceeds   | <br>\$ 25,235,047 |
| <br>Repayment of Lines of Credit  | <br>\$ 18,300,000 |
| Used for Working Capital  | \$ 6,935,047      |

Although the immediate use of \$18,300,000 of proceeds of the offering was the repayment of the Company's lines of credit, and the immediate use of \$6,935,047 was for working capital, purchases of real estate assets have been made by re-drawing on the lines of credit and using working capital. Therefore, the ultimate use of a substantial portion of the aggregate net offering proceeds may be regarded as being for the acquisition of real estate assets. For the year ended December 31, 2005, an aggregate of \$605,263 of our lines of credit was used to fund the excess of distributions to shareholders over our cash flow from operating activities, which may be characterized as a return of capital.

On October 2, 2006, the Board suspended the Public Offering.

**Item 3. Defaults Upon Senior Securities**

None.

**Item 4. Submission of Matters to a Vote of Security Holders**

None.

**Item 5. Other Information**

None.

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**Item 6. Exhibits**

| <b><u>Exhibit No.</u></b> | <b><u>Description</u></b>  |
|---------------------------|--|
| 3.1                       | Declaration of Trust of Hartman Commercial Properties REIT, a Maryland real estate investment trust (previously filed as and incorporated by reference to Exhibit 3.1 to the Registrant's Registration Statement on Form S-11/A, Commission File No. 333-111674, filed on May 24, 2004)  |
| 3.2                       | Articles of Amendment and Restatement of Declaration of Trust of Hartman Commercial Properties REIT (previously filed as and incorporated by reference to Exhibit 3.2 to the Registrant's Registration Statement on Form S-11/A, Commission File No. 333-111674, filed on July 29, 2004) |
| 3.3                       | Bylaws (previously filed as and incorporated by reference to Exhibit 3.2 to the Registrant's Registration Statement on Form S-11, Commission File No. 333-111674, filed on December 31, 2003)  |
| 4.1                       | Specimen certificate for common shares of beneficial interest, par value \$.001 (previously filed as and incorporated by reference to Exhibit 4.2 to the Registrant's Registration Statement on Form S-11, Commission File No. 333-111674, filed on December 31, 2003)                   |
| 10.1                      | Agreement of Limited Partnership of Hartman REIT Operating Partnership, L.P. (previously filed as and incorporated by reference to Exhibit 10.1 to the Registrant's General Form for Registration of Securities on Form 10, filed on April 30, 2003)                                     |
| 10.2                      | Amended and Restated Property Management Agreement (previously filed and incorporated by reference to Exhibit 10.2 to the Registrant's Form 10-K Annual Report for the year ended December 31, 2004, filed on March 31, 2005)  |
| 10.3                      | Advisory Agreement (previously filed and incorporated by reference to Exhibit 10.3 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2004, filed on March 31, 2005)   |
| 10.4                      | Certificate of Formation of Hartman REIT Operating Partnership II GP, LLC (previously filed as and incorporated by reference to Exhibit 10.3 to the Registrant's General Form for Registration of Securities on Form 10, filed on April 30, 2003)  |
| 10.5                      | Limited Liability Company Agreement of Hartman REIT Operating Partnership II GP, LLC (previously filed as and incorporated by reference to Exhibit 10.4 to the Registrant's General Form for Registration of Securities on Form 10, filed on April 30, 2003)                             |
| 10.6                      | Agreement of Limited Partnership of Hartman REIT Operating Partnership II, L.P. (previously filed as and incorporated by reference to Exhibit 10.6 to the Registrant's General Form for Registration of Securities on Form 10, filed on April 30, 2003)                                  |
| 10.7                      |  |

- Promissory Note, dated December 20, 2002, between Hartman REIT Operating Partnership II, L.P. and GMAC Commercial Mortgage Corporation (previously filed as and incorporated by reference to Exhibit 10.7 to the Registrant's General Form for Registration of Securities on Form 10, filed on April 30, 2003)
- 10.8 Deed of Trust and Security Agreement, dated December 20, 2002, between Hartman REIT Operating Partnership II, L.P. and GMAC Commercial Mortgage Corporation (previously filed as and incorporated by reference to Exhibit 10.8 to the Registrant's General Form for Registration of Securities on Form 10, filed on April 30, 2003)
- 10.9 Loan Agreement between Hartman REIT Operating Partnership, L.P. and Union Planter's Bank, N.A. (previously filed as and incorporated by reference to Exhibit 10.10 to Amendment No. 2 to the Registrant's General Form for Registration of Securities on Form 10, filed on August 6, 2003)
- 10.10 Employee and Trust Manager Incentive Plan (previously filed and incorporated by reference to Exhibit 10.9 to the Registrant's General Form for Registration of Securities on Form 10, filed on April 30, 2003)

**Exhibit**   **Description**  
**No.**

- 10.11   Summary Description of Hartman Commercial Properties REIT Trustee Compensation Arrangements (previously filed and incorporated by reference to Exhibit 10.11 of the Registrant's Annual Report on Form 10-K for the year ended December 31, 2004, filed on March 31, 2005)
- 10.12   Form of Agreement and Plan of Merger and Reorganization (previously filed as and incorporated by reference to the Registrant's Proxy Statement, filed on April 29, 2004)
- 10.13   Dealer Manager Agreement (previously filed and as incorporated by reference to Exhibit 10.13 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2004, Commission File No. 000-50256, Central Index Key No. 0001175535, filed on March 31, 2005)
- 10.14   Escrow Agreement (previously filed as and incorporated by reference to Exhibit 10.14 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2004, filed on March 31, 2005)
- 10.15   Form of Amendment to the Agreement of Limited Partnership of Hartman REIT Operating Partnership, L.P. (previously filed in and incorporated by reference to the Registrant's Registration Statement on Form S-11, Commission File No. 333-111674, filed on December 31, 2003)
- 10.16   Revolving Credit Agreement among Hartman REIT Operating Partnership, L.P., Hartman REIT Operating Partnership III LP, and KeyBank National Association (together with other participating lenders), dated June 2, 2005 (previously filed as and incorporated by reference to Exhibit 10.13 to Post-Effective Amendment No. 1 to the Registrant's Registration Statement on Form S-11, Commission File No. 333-111674, filed on June 17, 2005)
- 10.17   Form of Revolving Credit Note under Revolving Credit Agreement among Hartman REIT Operating Partnership, L.P., Hartman REIT Operating Partnership III LP, and KeyBank National Association (together with other participating lenders) (previously filed as and incorporated by reference to Exhibit 10.14 to Post-Effective Amendment No. 1 to the Registrant's Registration Statement on Form S-11, Commission File No. 333-111674, filed on June 17, 2005)
- 10.18   Guaranty under Revolving Credit Agreement among Hartman REIT Operating Partnership, L.P., Hartman REIT Operating Partnership III LP, and KeyBank National Association (together with other participating lenders) (previously filed as and incorporated by reference to Exhibit 10.15 to Post-Effective Amendment No. 1 to the Registrant's Registration Statement on Form S-11, Commission File No. 333-111674, filed on June 17, 2005)
- 10.19   Form of Negative Pledge Agreement under Revolving Credit Agreement among Hartman REIT Operating Partnership, L.P., Hartman REIT Operating Partnership III LP, and KeyBank National Association (together with other participating lenders)

(previously filed as and incorporated by reference to Exhibit 10.16 to Post-Effective Amendment No. 1 to the Registrant's Registration Statement on Form S-11, Commission File No. 333-111674, filed on June 17, 2005)

- 10.20 Form of Collateral Assignment of Partnership Interests under Revolving Credit Agreement among Hartman REIT Operating Partnership, L.P., Hartman REIT Operating Partnership III LP, and KeyBank National Association (together with other participating lenders) (previously filed as and incorporated by reference to Exhibit 10.17 to Post-Effective Amendment No. 1 to the Registrant's Registration Statement on Form S-11, Commission File No. 333-111674, filed on June 17, 2005)
- 10.21 Modification Agreement, dated as of February 28, 2006, between Hartman REIT Operating Partnership II, L.P. and GMAC Commercial Mortgage Corporation (previously filed and incorporated by reference to Exhibit 10.1 to the Registrant's Current Report on Form 8-K, filed March 3, 2006)
- 10.22 Interest Rate Swap Agreement dated as of March 16, 2006, between Hartman REIT Operating Partnership, L.P., Hartman REIT Operating Partnership III LP, and KeyBank National Association (previously filed and incorporated by reference to Exhibit 10.22 to the Registrant's Annual Report on Form 10-K, filed March 31, 2006)

**Exhibit**   **Description**  
**No.**

- 10.23      Waiver and Amendment No. 1, dated May 8, 2006, between Hartman REIT Operating Partnership, L.P., Hartman REIT Operating Partnership III, L.P., and KeyBank National Association, as agent for the consortium of lenders Association (previously filed and incorporated by reference to Exhibit 10.23 to the Registrant's Quarterly Report on Form 10-Q, filed May 12, 2006)
- 31.1\*      Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 31.2\*      Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 32.1\*      Certification of Chief Executive Officer Pursuant to 18 U.S.C., Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 32.2\*      Certification of Chief Financial Officer Pursuant to 18 U.S.C., Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

\*Filed herewith



**SIGNATURE**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

**HARTMAN COMMERCIAL PROPERTIES REIT**

Date: November 14, 2006

/s/ James C. Mastandrea  
James C. Mastandrea  
Chief Executive Officer

Dated November 14, 2006

/s/ John J. Dee  
John J. Dee  
Chief Financial Officer