

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 June 30, 2018

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: 001-38010

CLIPPER REALTY INC.

(Exact name of Registrant as specified in its charter)

Maryland

47-4579660

(State or other jurisdiction of incorporation or organization)

(I.R.S. Employer Identification No.)

4611 12th Avenue, Suite 1L

Brooklyn, New York 11219

(Address of principal executive offices) (Zip Code)

(718) 438-2804

(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:

<u>Title of Each Class</u>	<u>Name of Each Exchange on Which Registered</u>
Common Stock, par value \$0.01 per share	New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Act:

None

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company or an emerging growth company. See definition of "large accelerated filer," "accelerated filer," "smaller reporting company" and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated filer

Non-accelerated filer (Do not check if a smaller reporting company)

Smaller reporting company

Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

As of August 8, 2018, there were 17,812,755 shares of the Registrant's Common Stock outstanding.

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PART I – FINANCIAL INFORMATION

CAUTIONARY NOTE CONCERNING FORWARD-LOOKING STATEMENTS

All statements other than statements of historical fact included in this Quarterly Report on Form 10-Q for Clipper Realty Inc. (the “Company”), including, without limitation, statements under “Management’s Discussion and Analysis of Financial Condition and Results of Operations,” regarding the Company’s financial position, business strategy and the plans, objectives, expectations, or assumptions of management for future operations, are forward-looking statements. When used in this Quarterly Report on Form 10-Q, words such as “may,” “will,” “should,” “could,” “expect,” “anticipate,” “believe,” “estimate,” “project,” “predict,” “believe,” “expect,” “intend,” “continue,” “potential,” “plan,” “goal” or other words that convey the uncertainty of future events or outcomes are intended to identify forward-looking statements, which are generally not historical in nature. These statements involve risks and uncertainties that could cause actual results to differ materially from those described in such statements. These risks, contingencies and uncertainties include, but are not limited to, the following:

- market and economic conditions affecting occupancy levels, rental rates, the overall market value of our properties, our access to capital and the cost of capital and our ability to refinance indebtedness;
- economic or regulatory developments in New York City;
- the single government tenant in our commercial buildings may suffer financial difficulty;
- our ability to control operating costs to the degree anticipated;
- the risk of damage to our properties, including from severe weather, natural disasters, climate change and terrorist attacks;
- risks related to financing, cost overruns and fluctuations in occupancy rates and rents resulting from development or redevelopment activities and the risk that we may not be able to pursue or complete development or redevelopment activities or that such development or redevelopment activities may not be profitable;
- concessions or significant capital expenditures that may be required to attract and retain tenants;
- the relative illiquidity of real estate investments;
- competition affecting our ability to engage in investment and development opportunities or attract or retain tenants;
- unknown or contingent liabilities in properties acquired in formative and future transactions;
- changes in rent stabilization regulations or claims by tenants in rent-stabilized units that their rents exceed specified maximum amounts under current regulations;
- the possible effects of departure of key personnel in our management team on our investment opportunities and relationships with lenders and prospective business partners;
- conflicts of interest faced by members of management relating to the acquisition of assets and the development of properties, which may not be resolved in our favor;
- a transfer of a controlling interest in any of our properties may obligate us to pay transfer tax based on the fair market value of the real property transferred; and
- other risks and risk factors or uncertainties identified from time to time in our filings with the Securities and Exchange Commission (“SEC”).

Although the Company believes that the expectations reflected in such forward-looking statements are reasonable, it can give no assurance that such expectations will prove to have been correct. Reference is made to a more complete discussion of forward-looking statements and applicable risks contained under the captions “Cautionary Note Concerning Forward-Looking Statements” and “Risk Factors” in the Company’s Annual Report on Form 10-K for the year ended December 31, 2017, filed with the SEC on March 14, 2018, as amended, and other reports filed from time to time with the SEC. Clipper Realty Inc. undertakes no obligation to update or revise any of its forward-looking statements, whether as a result of new information, future events or otherwise.

ITEM 1. FINANCIAL STATEMENTS

Clipper Realty Inc.
Consolidated Balance Sheets
(In thousands, except for share and per share data)

	June 30, 2018	December 31, 2017
	(unaudited)	
ASSETS		
Investment in real estate		
Land and improvements	\$497,343	\$497,343
Building and improvements	471,155	463,727
Tenant improvements	3,030	3,023
Furniture, fixtures and equipment	10,535	10,245
Real estate under development	111,054	96,268
Total investment in real estate	1,093,117	1,070,606
Accumulated depreciation	(81,881)	(73,714)
Investment in real estate, net	1,011,236	996,892
Cash and cash equivalents	15,794	7,940
Restricted cash	12,456	13,730
Tenant and other receivables, net of allowance for doubtful accounts of \$2,356 and \$2,524, respectively	2,683	6,569
Deferred rent	3,001	3,514
Deferred costs and intangible assets, net	10,677	11,894
Prepaid expenses and other assets	12,347	11,546
TOTAL ASSETS	\$1,068,194	\$1,052,085
LIABILITIES AND EQUITY		
Liabilities:		
Notes payable, net of unamortized loan costs of \$11,132 and \$11,170, respectively	\$872,579	\$843,946
Accounts payable and accrued liabilities	12,000	8,595
Security deposits	6,680	6,048
Below-market leases, net	3,999	5,075
Other liabilities	3,294	2,830
TOTAL LIABILITIES	898,552	866,494
Equity:		
Preferred stock, \$0.01 par value; 100,000 shares authorized (including 140 shares of 12.5% Series A cumulative non-voting preferred stock), zero shares issued and outstanding	—	—
Common stock, \$0.01 par value; 500,000,000 shares authorized, 17,812,755 shares issued and outstanding	178	178
Additional paid-in-capital	92,726	92,273
Accumulated deficit	(24,429)	(17,539)
Total stockholders' equity	68,475	74,912
Non-controlling interests	101,167	110,679
TOTAL EQUITY	169,642	185,591
TOTAL LIABILITIES AND EQUITY	\$1,068,194	\$1,052,085

See accompanying notes to these consolidated financial statements.

Clipper Realty Inc.
Consolidated Statements of Operations
(In thousands, except per share data)
(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
REVENUES				
Residential rental income	\$19,670	\$18,079	\$38,968	\$36,116
Commercial income	5,375	5,471	10,752	10,942
Tenant recoveries	1,200	1,017	2,374	2,061
Garage and other income	1,055	791	2,074	1,502
TOTAL REVENUES	27,300	25,358	54,168	50,621
OPERATING EXPENSES				
Property operating expenses	6,581	6,564	13,837	13,669
Real estate taxes and insurance	5,362	4,817	10,710	9,469
General and administrative	2,606	2,588	5,744	4,784
Acquisition costs	—	6	—	27
Depreciation and amortization	4,435	4,063	9,031	7,998
TOTAL OPERATING EXPENSES	18,984	18,038	39,322	35,947
INCOME FROM OPERATIONS	8,316	7,320	14,846	14,674
Interest expense, net	(8,008)	(8,931)	(16,551)	(17,583)
Loss on extinguishment of debt	—	—	(6,981)	—
Net income (loss)	308	(1,611)	(8,686)	(2,909)
Net (income) loss attributable to non-controlling interests	(184)	965	5,180	1,798
Dividends attributable to preferred shares	—	(4)	—	(8)
Net income (loss) attributable to common stockholders	\$124	\$(650)	\$(3,506)	\$(1,119)
Basic and diluted net income (loss) per share	\$0.00	\$(0.04)	\$(0.20)	\$(0.08)

See accompanying notes to these consolidated financial statements.

Clipper Realty Inc.
Consolidated Statements of Equity
(In thousands, except for share data)
(Unaudited)

	Number of common shares	Common stock	Additional paid-in- capital	Accumulated deficit	Total stockholders' equity	Non- controlling interests	Total equity
Balance December 31, 2017	17,812,755	\$178	\$92,273	\$(17,539)	\$74,912	\$110,679	\$185,591
Issuance of common stock	—	—	(7)	—	(7)	—	(7)
Amortization of LTIP grants	—	—	—	—	—	1,259	1,259
Dividends and distributions	—	—	—	(3,384)	(3,384)	(5,131)	(8,515)
Net loss	—	—	—	(3,506)	(3,506)	(5,180)	(8,686)
Reallocation of noncontrolling interests	—	—	460	—	460	(460)	—
Balance June 30, 2018	<u>17,812,755</u>	<u>\$178</u>	<u>\$92,726</u>	<u>\$(24,429)</u>	<u>\$68,475</u>	<u>\$101,167</u>	<u>\$169,642</u>

See accompanying notes to these consolidated financial statements.

Clipper Realty Inc.
Consolidated Statements of Cash Flows
(In thousands)
(Unaudited)

	Six Months Ended June 30,	
	2018	2017
CASH FLOWS FROM OPERATING ACTIVITIES		
Net loss	\$(8,686)	\$(2,909)
<i>Adjustments to reconcile net loss to net cash provided by operating activities:</i>		
Depreciation	8,167	7,538
Amortization of deferred financing costs	752	1,442
Amortization of deferred costs and intangible assets	1,100	1,243
Amortization of above- and below-market leases	(959)	(866)
Loss on extinguishment of debt	6,981	—
Deferred rent	513	156
Stock-based compensation	1,259	1,429
Change in fair value of interest rate caps	(237)	329
<i>Changes in operating assets and liabilities:</i>		
Restricted cash	1,274	(2,290)
Tenant and other receivables	3,886	(86)
Prepaid expenses, other assets and deferred costs	(886)	(293)
Accounts payable and accrued liabilities	719	(2,220)
Security deposits	632	314
Other liabilities	464	541
Net cash provided by operating activities	14,979	4,328
CASH FLOWS FROM INVESTING ACTIVITIES		
Additions to land, buildings, and improvements	(19,246)	(8,578)
Proceeds from sale of interest rate caps	385	—
Acquisition deposit	—	(2,144)
Cash paid in connection with acquisition of real estate	—	(87,586)
Net cash used in investing activities	(18,861)	(98,308)
CASH FLOWS FROM FINANCING ACTIVITIES		
Proceeds and costs from sale of common stock	(7)	78,811
Redemption of preferred stock	—	(145)
Payments of mortgage notes	(579,989)	(681)
Proceeds from mortgage notes	608,585	59,000
Dividends and distributions	(8,515)	(8,056)
Loan issuance and extinguishment costs	(8,338)	(4,012)
Net cash provided by financing activities	11,736	124,917
Net increase in cash and cash equivalents	7,854	30,937
Cash and cash equivalents - beginning of period	7,940	37,547
Cash and cash equivalents - end of period	\$15,794	\$68,484
<i>Supplemental cash flow information:</i>		
Cash paid for interest, net of capitalized interest of \$2,541 and \$180 in 2018 and 2017, respectively	\$15,744	\$15,771
Other non-cash items capitalized to real estate under development	3,265	561

See accompanying notes to these consolidated financial statements.

Clipper Realty Inc.
Notes to Consolidated Financial Statements
(In thousands, except for share and per share data and as noted)
(Unaudited)

INTRODUCTION TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

We have prepared the unaudited condensed consolidated financial statements of Clipper Realty Inc. (the “Company” or “we”) and subsidiaries pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States (“GAAP”) have been condensed or omitted pursuant to such rules and regulations. We believe that the disclosures are adequate to make the information presented not misleading when read in conjunction with the financial statements and the notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2017, filed with the SEC on March 14, 2018, as amended.

The financial information presented reflects all adjustments (consisting of normal recurring adjustments) which are, in our opinion, necessary for a fair presentation of the results of operations, cash flows and financial position for the interim periods presented. These results are not necessarily indicative of a full year’s results of operations.

1. Organization

The Company was organized in the state of Maryland on July 7, 2015. On August 3, 2015, we completed certain formation transactions and the sale of shares of common stock in a private offering. We contributed the net proceeds of the private offering to Clipper Realty L.P., our operating partnership subsidiary (the “Operating Partnership”), in exchange for units in the Operating Partnership. The Operating Partnership in turn contributed such net proceeds to the limited liability companies (“LLCs”) that comprised the predecessor of the Company (the “Predecessor”) in exchange for class A LLC units in such LLCs and became the managing member of such LLCs. The owners of the LLCs exchanged their interests for Class B LLC units and an equal number of special, non-economic, voting stock in the Company. The Class B LLC units, together with the special voting shares, are convertible into common shares of the Company on a one-for-one basis and are entitled to distributions.

On February 9, 2017, the Company priced an initial public offering of 6,390,149 primary shares of its common stock (including the exercise of the over-allotment option, which closed on March 10, 2017) at a price of \$13.50 per share (the “IPO”). The net proceeds of the IPO were approximately \$78.7 million. We contributed the proceeds of the IPO to the Operating Partnership, in exchange for units in the Operating Partnership.

On May 9, 2017, the Company completed the purchase of 107 Columbia Heights, a 161-unit apartment community located in Brooklyn Heights, New York, in vacant condition, for \$87.5 million.

On October 27, 2017, the Company completed the acquisition of an 82-unit residential property at 10 West 65th Street in Manhattan, New York, for \$79.0 million.

As of June 30, 2018, the properties owned by the Company consist of the following (collectively, the “Properties”):

- Tribeca House in Manhattan, comprising two buildings, one with 21 stories and one with 12 stories, containing residential and retail space with an aggregate of approximately 481,000 square feet of residential rental Gross Leasable Area (“GLA”) and 77,000 square feet of retail rental and parking GLA;
- Flatbush Gardens in Brooklyn, a 59-building residential housing complex with 2,496 rentable units;
- 141 Livingston Street in Brooklyn, a 15-story office building with approximately 216,000 square feet of GLA;
- 250 Livingston Street in Brooklyn, a 12-story office and residential building with approximately 381,000

square feet of GLA (fully remeasured);

- Aspen in Manhattan, a 7-story building containing residential and retail space with approximately 166,000 square feet of residential rental GLA and approximately 21,000 square feet of retail rental GLA;
- 107 Columbia Heights in Brooklyn, a 10-story residential building with approximately 154,000 gross square feet of space; and
- 10 West 65th Street in Manhattan, a 6-story building with approximately 76,000 square feet of residential rental GLA.

The operations of Clipper Realty, Inc. and its consolidated subsidiaries are carried on primarily through the Operating Partnership. The Company has elected to be taxed as a Real Estate Investment Trust (“REIT”) under Sections 856 through 860 of the Internal Revenue Code. The Company is the sole general partner of the Operating Partnership and the Operating Partnership is the sole managing member of the LLCs that comprised the Predecessor.

At June 30, 2018, the Company’s interest, through the Operating Partnership, in the LLCs that own the properties generally entitles it to 40.4% of the aggregate cash distributions from, and the profits and losses of, the LLCs.

Upon adoption of Accounting Standards Update (“ASU”) 2015-02, the Company determined that the Operating Partnership and the LLCs are variable interest entities (“VIEs”) and that the Company was the primary beneficiary. The assets and liabilities of these VIEs represented substantially all of the Company’s assets and liabilities.

2. Sale of Common Stock, Formation Transactions and Preferred Stock Redemption

As discussed in Note 1, in February 2017, the Company sold an aggregate of 6,390,149 primary shares of common stock (including the exercise of the over-allotment option, which closed on March 10, 2017) to investors in a public offering at \$13.50 per share. The proceeds, net of offering costs, were approximately \$78,970.

The Company contributed the net proceeds of the common stock offerings to the Operating Partnership in exchange for units in the Operating Partnership as described in Note 1.

On June 21, 2017, the Company redeemed its Series A cumulative non-voting preferred stock for \$145.

3. Significant Accounting Policies

Basis of Consolidation

The accompanying consolidated financial statements of the Company are prepared in accordance with GAAP. The effect of all intercompany balances has been eliminated. The consolidated financial statements include the accounts of all entities in which the Company has a controlling interest. The ownership interests of other investors in these entities are recorded as non-controlling interest.

Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of commitments and contingencies at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could materially differ from these estimates.

Investment in Real Estate

Real estate assets held for investment are carried at historical cost and consist of land, buildings and improvements, furniture, fixtures and equipment. Expenditures for ordinary repair and maintenance costs are charged to expense as incurred. Expenditures for improvements, renovations, and replacements of real estate assets are capitalized and depreciated over their estimated useful lives if the expenditures qualify as betterment or the life of the related asset will be substantially extended beyond the original life expectancy.

In accordance with ASU 2017-01, “Business Combinations – Clarifying the Definition of a Business,” the

Company evaluates each acquisition of real estate or in-substance real estate to determine if the integrated set of assets and activities acquired meets the definition of a business and needs to be accounted for as a business combination. If either of the following criteria is met, the integrated set of assets and activities acquired would not qualify as a business:

- Substantially all of the fair value of the gross assets acquired is concentrated in either a single identifiable asset or a group of similar identifiable assets; or
- The integrated set of assets and activities is lacking, at a minimum, an input and a substantive process that together significantly contribute to the ability to create outputs (i.e., revenue generated before and after the transaction).

An acquired process is considered substantive if:

- The process includes an organized workforce (or includes an acquired contract that provides access to an organized workforce) that is skilled, knowledgeable and experienced in performing the process;
- The process cannot be replaced without significant cost, effort or delay; or
- The process is considered unique or scarce.

Generally, the Company expects that acquisitions of real estate or in-substance real estate will not meet the revised definition of a business because substantially all of the fair value is concentrated in a single identifiable asset or group of similar identifiable assets (i.e., land, buildings and related intangible assets) or because the acquisition does not include a substantive process in the form of an acquired workforce or an acquired contract that cannot be replaced without significant cost, effort or delay.

Upon acquisition of real estate, the Company assesses the fair values of acquired tangible and intangible assets including land, buildings, tenant improvements, above-market and below-market leases, in-place leases and any other identified intangible assets and assumed liabilities. The Company allocates the purchase price to the assets acquired and liabilities assumed based on their fair values. In estimating fair value of tangible and intangible assets acquired, the Company assesses and considers fair value based on estimated cash flow projections that utilize appropriate discount and capitalization rates, estimates of replacement costs, net of depreciation, and available market information. The fair value of the tangible assets of an acquired property considers the value of the property as if it were vacant.

The Company records acquired above-market and below-market lease values initially based on the present value, using a discount rate which reflects the risks associated with the leases acquired based on the difference between (i) the contractual amounts to be paid pursuant to each in-place lease and (ii) management's estimate of fair market lease rates for each corresponding in-place lease, measured over a period equal to the remaining term of the lease for above-market leases and the initial term plus the term of any below-market fixed renewal options for the below-market leases. Other intangible assets acquired include amounts for in-place lease values and tenant relationship values (if any) that are based on management's evaluation of the specific characteristics of each tenant's lease and the Company's overall relationship with the respective tenant. Factors to be considered by management in its analysis of in-place lease values include an estimate of carrying costs to execute similar leases. In estimating carrying costs, management includes real estate taxes, insurance and other operating expenses and estimates of lost rentals at market rates during the expected lease-up periods, depending on local market conditions. In estimating costs to execute similar leases, management considers leasing commissions, legal and other related expenses.

The Company reviews long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. A property's value is impaired if management's estimate of the aggregate future cash flows (undiscounted and without interest charges) to be generated by the property is less than the carrying value of the property. To the extent impairment has occurred, a write-down is recorded and measured by the amount of the difference between the carrying value of the asset and the fair value of the asset. Management of the Company does not believe that any of its properties within the portfolio are impaired as of June 30, 2018.

For long-lived assets to be disposed of, impairment losses are recognized when the fair value of the assets less estimated cost to sell is less than the carrying value of the assets. Properties classified as real estate held-for-sale

generally represent properties that are actively marketed or contracted for sale with closing expected to occur within the next twelve months. Real estate held-for-sale is carried at the lower of cost, net of accumulated depreciation, or fair value less cost to sell, determined on an asset-by-asset basis. Expenditures for ordinary repair and maintenance costs on held-for-sale properties are charged to expense as incurred. Expenditures for improvements, renovations, and replacements related to held-for-sale properties are capitalized at cost. Depreciation is not recorded on real estate held-for-sale.

If a tenant vacates its space prior to the contractual termination of the lease and no rental payments are being made on the lease, any unamortized balances of the related intangibles are written off. The tenant improvements and origination costs are amortized to expense over the remaining life of the lease (or charged against earnings if the lease is terminated prior to its contractual expiration date).

Depreciation is computed using the straight-line method over the estimated useful lives of the assets as follows:

Building and improvements	10–44 years
Tenant improvements	Shorter of useful life or lease term
Furniture, fixtures and equipment	3–15 years

The capitalized above-market lease values are amortized as a reduction to base rental revenue over the remaining terms of the respective leases, and the capitalized below-market lease values are amortized as an increase to base rental revenue over the remaining initial terms plus the terms of any below-market fixed rate renewal options of the respective leases. The value of in-place leases is amortized to expense over the remaining initial terms of the respective leases.

Cash and Cash Equivalents

Cash and cash equivalents are defined as cash on hand and in banks, plus all short-term investments with a maturity of three months or less when purchased. The Company maintains some of its cash in bank deposit accounts, which, at times, may exceed the federally insured limit. No losses have been experienced related to such accounts.

Restricted Cash

Restricted cash generally consists of escrows for future real estate taxes and insurance expenditures, repairs and capital improvements and security deposits.

Tenant and Other Receivables and Allowance for Doubtful Accounts

Tenant and other receivables are comprised of amounts due for monthly rents and other charges. The Company periodically performs a detailed review of amounts due from tenants to determine if accounts receivable balances are impaired based on factors affecting the collectability of those balances. If a tenant fails to make contractual payments beyond any allowance, the Company may recognize additional bad debt expense in future periods.

Deferred Costs

Deferred lease costs consist of fees incurred to initiate and renew operating leases. Lease costs are being amortized using the straight-line method over the terms of the respective leases.

Deferred financing costs represent commitment fees, legal and other third-party costs associated with obtaining financing. These costs are amortized over the term of the financing and are recorded in interest expense in the consolidated financial statements. Unamortized deferred financing costs are expensed when the associated debt is refinanced or repaid before maturity. Costs incurred in seeking financing transactions which do not close are expensed in the period the financing transaction is terminated.

Comprehensive Income (Loss)

Comprehensive income (loss) is comprised of net income (loss) adjusted for changes in unrealized gains and

losses, reported in equity, for financial instruments required to be reported at fair value under GAAP. For the three and six months ended June 30, 2018 and 2017, the Company did not own any financial instruments for which the change in value was not reported in net income (loss) accordingly and its comprehensive income (loss) was its net income (loss) as presented in the consolidated statements of operations.

Revenue Recognition

Rental revenue for commercial leases is recognized on a straight-line basis over the terms of the respective leases. Rental income attributable to residential leases and parking is recognized as earned, which is not materially different from the straight-line basis. Leases entered into by residents for apartment units are generally for one-year terms, renewable upon consent of both parties on an annual or monthly basis. Deferred rents receivable represents the amount by which straight-line rental revenue exceeds rents currently billed in accordance with lease agreements.

Reimbursements for operating expenses due from tenants pursuant to their lease agreements are recognized as revenue in the period the applicable expenses are incurred. These costs generally include real estate taxes, utilities, insurance, common area maintenance costs and other recoverable costs.

Beginning in 2019, the Company will apply ASU 2014-09, "Revenue with Contracts with Customers." This ASU does not apply to the Company's lease revenues, which made up substantially all revenues in 2017 and the first two quarters of 2018. As such, management does not anticipate any significant changes to the timing of the Company's revenue recognition. The Company intends to implement the standard retrospectively at the date of adoption.

Beginning in 2020, the Company will be required to apply ASU 2016-02, "Leases," to its lease revenues. For lessors, the accounting remains largely unchanged from the current model. The adoption of ASU 2016-02 is not expected to have a material impact on the Company's consolidated financial statements.

Stock-based Compensation

The Company accounts for stock-based compensation pursuant to Financial Accounting Standards Board Accounting Standards Codification ("FASB ASC") Topic 718, "Compensation — Stock Compensation." As such, all equity-based awards are reflected as compensation expense in the Company's consolidated financial statements over their vesting period based on the fair value at the date of grant.

In March 2018, the Company granted 71,112 LTIP units with a weighted average grant date fair value of \$9.00 per unit.

At June 30, 2018 and December 31, 2017, there were 724,448 and 653,336 LTIP units outstanding, respectively, with a weighted grant-date fair value of \$12.56 and \$12.95 per unit, respectively. As of June 30, 2018, and December 31, 2017, there was \$1.5 million and \$2.1 million, respectively, of total unrecognized compensation cost related to unvested share-based compensation arrangements granted under share incentive plans. As of June 30, 2018, the weighted average period over which the unrecognized compensation expense will be recorded is approximately 1.4 years.

Income Taxes

The Company elected to be taxed and to operate in a manner that will allow it to qualify as a REIT under the U.S. Internal Revenue Code (the "Code") commencing with its taxable year ended December 31, 2015. To qualify as a REIT, the Company is required to distribute dividends equal to at least 90% of the REIT taxable income (computed without regard to the dividends paid deduction and net capital gains) to its stockholders, and meet the various other requirements imposed by the Code relating to matters such as operating results, asset holdings, distribution levels and diversity of stock ownership. Provided the Company qualifies for taxation as a REIT, it is generally not subject to U.S. federal corporate-level income tax on the earnings distributed currently to its stockholders. If the Company fails to qualify as a REIT in any taxable year, the Company will be subject to U.S. federal and state income tax on its taxable income at regular corporate tax rates and any applicable alternative minimum tax. In addition, the Company may not be able to re-elect as a REIT for the four subsequent taxable years. The entities comprising the Predecessor are limited liability companies and are treated as pass-through entities for income tax purposes. Accordingly, no provision has been made for federal, state or local income or franchise taxes

in the accompanying consolidated financial statements.

In accordance with FASB ASC Topic 740, the Company believes that it has appropriate support for the income tax positions taken and, as such, does not have any uncertain tax positions that, if successfully challenged, could result in a material impact on its or the Predecessor's financial position or results of operations. The prior three years' income tax returns are subject to review by the Internal Revenue Service.

The Tax Cuts and Jobs Act was enacted in December 2017 and is generally effective beginning in 2018. This new legislation is not expected to have a material adverse effect on the Company's business and contains several potentially favorable provisions.

Fair Value Measurements

Refer to Note 9, "Fair Value of Financial Instruments".

Derivative Financial Instruments

FASB derivative and hedging guidance establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities. As required by FASB guidance, the Company records all derivatives on the consolidated balance sheets at fair value. The accounting for changes in the fair value of derivatives depends on the intended use of the derivative and the resulting designation.

Derivatives used to hedge the exposure to changes in the fair value of an asset, liability, or firm commitment attributable to a particular risk, such as interest rate risk, are considered fair value hedges. Derivatives used to hedge the exposure to variability in expected future cash flows, or other types of forecast transactions, are considered cash flow hedges. For derivatives designated as fair value hedges, changes in the fair value of the derivative and the hedged item related to the hedged risk are recognized in earnings. For derivatives designated as cash flow hedges, the effective portion of changes in the fair value of the derivative is initially reported in other comprehensive income (outside of earnings) and subsequently reclassified to earnings when the hedged transaction affects earnings, and the ineffective portion of changes in the fair value of the derivative is recognized directly in earnings. The Company assesses the effectiveness of each hedging relationship by comparing the changes in the fair value or cash flows of the derivative hedging instrument with the changes in the fair value or cash flows of the designated hedged item or transaction. For derivatives not designated as hedges, changes in fair value would be recognized in earnings. As of June 30, 2018, the Company has no derivatives for which it applies hedge accounting.

Income (Loss) Per Share

Basic and diluted income (loss) per share is computed by dividing net income (loss) attributable to common stockholders by the weighted average common shares outstanding. As of June 30, 2018 and 2017, the Company had unvested LTIP Units which provide for non-forfeitable rights to dividend-equivalent payments. Accordingly, these unvested LTIP Units are considered participating securities and are included in the computation of basic and diluted income (loss) per share pursuant to the two-class method. The Company did not have dilutive securities as of June 30, 2018 or 2017.

The effect of the conversion of the 26,317 Class B LLC units outstanding is not reflected in the computation of basic and diluted income (loss) per share, as the effect would be anti-dilutive. The net income (loss) allocable to such units is reflected as noncontrolling interests in the accompanying consolidated financial statements.

The following table sets forth the computation of basic and diluted income (loss) per share for the periods indicated (unaudited):

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2018	2017	2018	2017
(in thousands, except per share amounts)				
<u>Numerator</u>				
Net income (loss) attributable to common stockholders	\$124	\$(650)	\$(3,506)	\$(1,119)
Less: income attributable to participating securities	(69)	(62)	(131)	(105)
Subtotal	\$55	\$(712)	\$(3,637)	\$(1,224)
<u>Denominator</u>				
Weighted average common shares outstanding	17,813	17,813	17,813	16,228
Basic and diluted net income (loss) per share attributable to common stockholders	\$0.00	\$(0.04)	\$(0.20)	\$(0.08)

Recently Issued Pronouncements

In July 2018, FASB issued ASU 2018-11, “Leases (Topic 842): Targeted Improvements,” which amended ASC 842 to provide a practical expedient to lessors to elect to not separate nonlease components from the associated leases. The Company is currently assessing the impact this guidance will have on its consolidated financial statements.

In July 2018, FASB issued ASU 2018-10, “Codification Improvements to Topic 842, Leases.” These amendments provide clarifications and corrections to ASU 2016-02, “Leases (Topic 842).” The Company is currently assessing the impact this guidance will have on its consolidated financial statements.

In July 2018, FASB issued ASU 2018-09, “Codification Improvements.” These amendments provide clarifications and corrections to certain ASC subtopics including the following: 470-50 (Debt – Modifications and Extinguishments), 480-10 (Distinguishing Liabilities from Equity – Overall), 718-740 (Compensation – Stock Compensation – Income Taxes), 805-740 (Business Combinations – Income Taxes), 815-10 (Derivatives and Hedging – Overall) and 820-10 (Fair Value Measurement – Overall). The Company is currently assessing the impact this guidance will have on its consolidated financial statements.

In June 2018, FASB issued ASU 2018-07, “Compensation – Stock Compensation (Topic 718): Improvements to Nonemployee Share-Based Payment Accounting.” These amendments provide specific guidance for transactions for acquiring goods and services from nonemployees and specify that Topic 718 applies to all share-based payment transactions in which a grantor acquires goods or services to be used or consumed in a grantor’s own operations by issuing share-based payment awards. The amendments also clarify that Topic 718 does not apply to share-based payments used to effectively provide (i) financing to the issuer or (ii) awards granted in conjunction with selling goods or services to customers as part of a contract accounted for under Topic 606, “Revenue from Contracts with Customers.” This guidance is effective for the Company for fiscal years beginning after December 15, 2019, and interim periods beginning after December 15, 2020. Early adoption is permitted but not earlier than the adoption of Topic 606. The Company does not believe that this guidance will have a material effect on its consolidated financial statements as it has not historically issued share-based payments in exchange for goods or services to be consumed within its operations.

In May 2017, FASB issued ASU 2017-09, “Compensation – Stock Compensation (Topic 718) Scope of Modification Accounting.” ASU 2017-09 clarifies Topic 718 such that an entity must apply modification accounting to changes in the terms or conditions of a share-based payment award *unless* all of the following criteria are met:

1. The fair value of the modified award is the same as the fair value of the original award immediately before the modification. The standard indicates that if the modification does not affect any of the inputs to the

valuation technique used to value the award, the entity is not required to estimate the value immediately before and after the modification.

2. The vesting conditions of the modified award are the same as the vesting conditions of the original award immediately before the modification.
3. The classification of the modified award as an equity instrument or a liability instrument is the same as the classification of the original award immediately before the modification.

The amendments are effective for all entities for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The adoption of ASU 2017-09 did not have a material impact on our consolidated financial statements.

In February 2017, FASB issued ASU 2017-05, “Other Income-Gains and Losses from the Derecognition of Nonfinancial Assets (Subtopic 610-20),” to add guidance for partial sales of nonfinancial assets, including partial sales of real estate. Historically, U.S. GAAP contained several different accounting models to evaluate whether the transfer of certain assets qualified for sale treatment. ASU 2017-05 reduces the number of potential accounting models that might apply and clarifies which model does apply in various circumstances. ASU 2017-05 is effective for public companies and for emerging growth companies for annual reporting periods beginning after December 15, 2017 and 2018, respectively, including interim reporting periods beginning after December 15, 2017 and December 15, 2019, respectively. The adoption of ASU 2017-05 is not expected to have a material impact on our consolidated financial statements.

In November 2016, the FASB issued ASU 2016-18 “Statement of Cash Flows (Topic 230) – Restricted Cash”. The ASU requires that a statement of cash flows explain the change during the period in the total of cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents. Therefore, amounts generally described as restricted cash and restricted cash equivalents should be included with cash and cash equivalents when reconciling the beginning-of-period and end-of-period total amounts shown on the statement of cash flows. The ASU does not provide a definition of restricted cash or restricted cash equivalents. The ASU is effective for public business entities, other than emerging growth companies, for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. For all other entities, the ASU is effective for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019. Early adoption is permitted, including adoption in an interim period. The Company is currently evaluating the effect that ASU No. 2016-18 will have on its consolidated financial statements.

In August 2016, the FASB issued ASU 2016-15, “Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments (A consensus of the Emerging Issues Task Force),” which provides specific guidance on eight cash flow classification issues and how to reduce diversity in how certain cash receipts and cash payments are presented and classified in the statement of cash flows. The effective date of this standard for public business entities, other than emerging growth companies, will be fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017. For all other entities, the ASU is effective for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019. Early adoption is permitted. The Company is currently evaluating the new guidance to determine the impact, if any, it will have on its consolidated financial statements.

4. Acquisitions

On October 27, 2017, the Company acquired the 10 West 65th Street property for \$79,764, including acquisition costs of \$764.

The purchase price was allocated as follows:

Land	\$63,677
Building	14,983
Tenant improvements	18
Furniture and office equipment	336
Leasing commissions	13
In-place leases	732
Other lease-up costs	5
Total	<u>\$79,764</u>

We have prepared the following unaudited pro forma income statement information for the six months ended June 30, 2017, as if the 10 West 65th Street acquisition had occurred as of January 1, 2017. The pro forma data is not necessarily indicative of the results that actually would have occurred if the acquisition had been consummated on January 1, 2017.

	Six Months Ended
	June 30,
	2017
	<hr/>
Revenues	\$52,105
Total expenses	<u>(55,915)</u>
Net loss	<u><u>\$(3,810)</u></u>

On May 9, 2017, the Company acquired the 107 Columbia Heights property, in vacant condition, for \$87,616, including acquisition costs of \$116.

The purchase price was allocated as follows:

Land	\$43,433
Building	44,100
Site improvements	83
Total	<u>\$87,616</u>

5. Deferred Costs and Intangible Assets

Deferred costs and intangible assets consist of the following:

	June 30,	December 31,
	2018	2017
	<hr/>	<hr/>
	(unaudited)	
Deferred costs	\$266	\$266
Above-market leases	480	480
Lease origination costs	3,110	3,110
In-place leases	8,078	8,078
Real estate tax abatements	12,571	12,571
Total deferred costs and intangible assets	<u>24,505</u>	<u>24,505</u>
Less accumulated amortization	<u>(13,828)</u>	<u>(12,611)</u>
Total deferred costs and intangible assets, net	<u>\$10,677</u>	<u>\$11,894</u>

Amortization of lease origination costs and in-place lease intangible assets was \$311 and \$230 for the three months ended June 30, 2018 and 2017, respectively, and \$864 and \$460 for the six months ended June 30, 2018 and 2017, respectively. Amortization of real estate abatements of \$118 and \$391 for the three months ended June 30, 2018 and 2017, respectively, and \$236 and \$783 for the six months ended June 30, 2018 and 2017, respectively, is included in real estate taxes and insurance in the consolidated statements of operations. Amortization of above-market leases of \$58 and \$15 for the three months ended June 30, 2018 and 2017, respectively, and \$117 and \$28 for the six months ended June 30, 2018 and 2017, respectively, is included in commercial income in the consolidated statements of operations.

Deferred costs and intangible assets as of June 30, 2018, amortize in future years as follows:

2018 (Remainder)	\$737
2019	1,134
2020	798
2021	768
2022	737
Thereafter	6,503
Total	<u>\$10,677</u>

6. Below-Market Lease Intangibles

The Company's below-market lease intangibles liabilities are as follows:

	June 30, 2018	December 31, 2017
	(unaudited)	
Below-market leases	\$23,178	\$23,178
Less accumulated amortization	(19,179)	(18,103)
Below-market leases, net	<u>\$3,999</u>	<u>\$5,075</u>

Rental income includes amortization of below-market leases of \$538 and \$447 for the three months ended June 30, 2018 and 2017, respectively, and \$1,076 and \$894 for the six months ended June 30, 2018 and 2017, respectively.

Below-market leases as of June 30, 2018, amortize in future years as follows:

2018 (Remainder)	\$1,075
2019	1,299
2020	517
2021	493
2022	423
Thereafter	192
Total	<u>\$3,999</u>

7. Notes Payable

The mortgages, loans and mezzanine notes payable collateralized by the properties, or the Company's interest in the entities that own the properties and assignment of leases, are as follows:

Property	Maturity	Interest Rate	June 30, 2018	December 31, 2017
Flatbush Gardens, Brooklyn, NY (a)	10/1/2024	3.88%	—	\$148,438
Flatbush Gardens, Brooklyn, NY (a)	10/1/2024	3.88%	—	19,792
Flatbush Gardens, Brooklyn, NY (a)	3/1/2028	3.50%	\$246,000	—
250 Livingston Street, Brooklyn, NY (b)	5/6/2023	4.00%	33,906	34,294
141 Livingston Street, Brooklyn, NY (c)	6/1/2028	3.875%	78,069	78,792
Tribeca House, Manhattan, NY (d)	11/9/2018	LIBOR + 3.75%	—	410,000
Tribeca House, Manhattan, NY (d)	3/6/2028	4.506%	360,000	—
Aspen, Manhattan, NY (e)	7/1/2028	3.68%	68,734	69,383
107 Columbia Heights, Brooklyn, NY (f)	5/9/2020	LIBOR + 3.85%	62,652	60,067
10 West 65 th Street, Manhattan, NY (g)	11/1/2027	3.375%	34,350	34,350
Total debt			<u>\$883,711</u>	<u>\$855,116</u>
Unamortized debt issuance costs			(11,132)	(11,170)
Total debt, net of unamortized debt issuance costs			<u>\$872,579</u>	<u>\$843,946</u>

(a) On February 21, 2018, the Company repaid the debt secured by the Flatbush Gardens property that was scheduled to mature in 2024, from the proceeds of a \$246,000 first mortgage loan with New York Community Bank

(“NYCB”). The loan matures on March 1, 2028, and bears interest at 3.5% for the first five years and thereafter at the prime rate plus 2.75%, subject to an option to fix the rate. The loan requires interest-only payments through August 2020, and monthly principal and interest payments thereafter based on a 30-year amortization schedule.

(b) The \$37,500 mortgage note agreement with Citigroup Global Markets Realty Corp. matures on May 6, 2023, and bears interest at 4.00%. The note requires monthly principal and interest payments of \$179.

(c) The NYCB loan matures on June 1, 2028, and bears interest at 3.875%. The note required interest-only payments through June 2017, and monthly principal and interest payments of \$374 thereafter based on a 30-year amortization schedule.

(d) On February 21, 2018, the Company repaid the \$410,000 loan package secured by the Tribeca House property with the proceeds of a \$360,000 loan with Deutsche Bank and cash on hand. The loan matures on March 6, 2028, bears interest at 4.506% and requires interest-only payments for the entire term.

(e) The \$70,000 mortgage note agreement with Capital One Multifamily Finance LLC matures on July 1, 2028, and bears interest at 3.68%. The note required interest-only payments through July 2017, and monthly principal and interest payments of \$321 thereafter based on a 30-year amortization schedule.

(f) On May 9, 2017, the Company entered into a \$59,000 mortgage note agreement with a unit of Blackstone Mortgage Trust, Inc., related to the 107 Columbia Heights acquisition. The Company also entered into a construction loan secured by the building with the same lender that will provide up to \$14,700 for eligible capital improvements and carrying costs, of which \$3,652 was drawn as of June 30, 2018. The notes mature on May 9, 2020, are subject to two one-year extension options, require interest-only payments and bear interest at one-month LIBOR plus 3.85% (5.9% as of June 30, 2018).

(g) On October 27, 2017, the Company entered into a \$34,350 mortgage note agreement with NYCB, related to the 10 West 65th Street acquisition. The note matures on November 1, 2027, and bears interest at 3.375% for the first five years and thereafter at the prime rate plus 2.75%, subject to an option to fix the rate. The note requires interest-only payments through October 2019, and monthly principal and interest payments thereafter based on a 30-year amortization schedule.

The following table summarizes principal payment requirements under terms as of June 30, 2018:

2018 (Remainder)	\$1,593
2019	3,763
2020	68,670
2021	9,422
2022	9,770
Thereafter	790,493
Total	<u><u>\$883,711</u></u>

The Company recognized a loss on extinguishment of debt of approximately \$6,981 during the three months ended March 31, 2018. The loss consisted of prepayment and other fees and the write-off of unamortized loan costs.

8. Rental Income under Operating Leases

The Company’s commercial properties are leased to commercial tenants under operating leases with fixed terms of varying lengths. As of June 30, 2018, the minimum future cash rents receivable (excluding tenant reimbursements for operating expenses) under non-cancelable operating leases for the commercial tenants in each of the next five years and thereafter are as follows:

2018 (Remainder)	\$11,111
2019	17,335
2020	10,316
2021	4,695
2022	4,260
Thereafter	12,680
Total	<u><u>\$60,397</u></u>

The Company has commercial leases with the City of New York that comprised approximately 19% and 20% of total revenues for the three months ended June 30, 2018 and 2017, respectively, and 19% and 20% of total revenues for the six months ended June 30, 2018 and 2017, respectively.

9. Fair Value of Financial Instruments

GAAP requires the measurement of certain financial instruments at fair value on a recurring basis. In addition, GAAP requires the measure of other financial instruments and balances at fair value on a non-recurring basis (e.g., carrying value of impaired real estate and long-lived assets). Fair value is defined as the price that would be received upon the sale of an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The GAAP fair value framework uses a three-tiered approach. Fair value measurements are classified and disclosed in one of the following three categories:

- Level 1: unadjusted quoted prices in active markets that are accessible at the measurement date for identical assets or liabilities;
- Level 2: quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-derived valuations in which significant inputs and significant value drivers are observable in active markets; and
- Level 3: prices or valuation techniques where little or no market data is available that require inputs that are both significant to the fair value measurement and unobservable.

When available, the Company utilizes quoted market prices from an independent third-party source to determine fair value and classifies such items in Level 1 or Level 2. In instances where the market for a financial instrument is not active, regardless of the availability of a nonbinding quoted market price, observable inputs might not be relevant and could require the Company to make a significant adjustment to derive a fair value measurement. Additionally, in an inactive market, a market price quoted from an independent third party may rely more on models with inputs based on information available only to that independent third party. When the Company determines the market for a financial instrument owned by the Company to be illiquid or when market transactions for similar instruments do not appear orderly, the Company uses several valuation sources (including internal valuations, discounted cash flow analysis and quoted market prices) and establishes a fair value by assigning weights to the various valuation sources.

Changes in assumptions or estimation methodologies can have a material effect on these estimated fair values. In this regard, the derived fair value estimates cannot be substantiated by comparison to independent markets and, in many cases, may not be realized in an immediate settlement of the instrument.

The financial assets and liabilities in the consolidated balance sheets include cash and cash equivalents, restricted cash, receivables, interest rate caps, accounts payable and accrued liabilities, and notes payable. The carrying amount of cash and cash equivalents, restricted cash, receivables, and accounts payable and accrued liabilities reported in the consolidated balance sheets approximates fair value due to the short-term nature of these instruments. The fair value of notes payable, which are classified as Level 2, is estimated by discounting the contractual cash flows of each debt instrument to their present value using adjusted market interest rates.

The carrying amount and estimated fair value of the notes payable are as follows:

	June 30, 2018	December 31, 2017
	(unaudited)	
Carrying amount (excluding unamortized debt issuance costs)	\$883,711	\$855,116
Estimated fair value	\$873,479	\$839,753

The Company purchased interest rate caps in connection with the Tribeca House loans obtained on November 9, 2016, and in connection with the loans obtained for the 107 Columbia Heights acquisition. On April 27, 2018, the Company terminated the Tribeca House instrument for net proceeds of \$385. The fair value of the interest rate caps, which are classified as Level 2, is estimated using market inputs and credit valuation inputs.

The estimated fair values of the interest rate caps are as follows:

Notional Amount	Related Property Loans	Maturity Date	Strike Rate	Estimated Fair Value at June 30, 2018	Estimated Fair Value at December 31, 2017
\$410,000	Tribeca House	December 15, 2018	2.0%	—	\$148
\$73,700	107 Columbia Heights	May 9, 2020	3.0%	\$97	34
Total fair value of derivative instruments included in prepaid expenses and other assets				\$97	\$182

These interest rate caps were not designated as hedges; accordingly, changes in fair value of the Tribeca House instrument are recognized in earnings, and changes in fair value of the 107 Columbia Heights instrument are recognized in real estate under development. (Increases) decreases in fair value of the Tribeca House instrument of \$(10) and \$192 for the three months ended June 30, 2018 and 2017, respectively, and \$(237) and \$329 for the six months ended June 30, 2018 and 2017, respectively, are included in interest expense. (Increases) decreases in fair value of the 107 Columbia Heights instrument of \$6 and \$63 for the three months ended June 30, 2018 and 2017, respectively, and \$(63) and \$63 for the six months ended June 30, 2018 and 2017, respectively, are recognized in interest expense and capitalized to real estate under development.

The above disclosures regarding fair value of financial instruments are based on pertinent information available as of June 30, 2018, and December 31, 2017, respectively. Although the Company is not aware of any factors that would significantly affect the reasonableness of the estimated fair value amounts, such amounts have not been comprehensively revalued for purposes of these financial statements since those dates, and current estimates of fair value may differ significantly from the amounts presented herein.

10. Commitments and Contingencies

Legal

On July 3, 2017, the New York Supreme Court (the “Court”) ruled in favor of 41 present or former tenants of apartment units at the Company’s buildings located at 50 Murray Street and 53 Park Place in Manhattan, New York, who brought an action against the Company alleging that they were subject to applicable rent stabilization laws with the result that rental payments charged by the Company exceeded amounts permitted under these laws because the buildings were receiving certain tax abatements under Real Property Tax Law 421-g. The Court also awarded the plaintiffs, their attorney’s fees and costs. The Court declared that the plaintiff-tenants were subject to rent stabilization requirements and referred the matter to a special referee to determine the amount of rent over-charges, if any. On July 18, 2017, the Court stayed the above decision; the Company subsequently appealed the decision to the Appellate Division, First Department. On January 18, 2018, the Appellate Division unanimously ruled in favor of the Company, holding that the Company acted properly in de-regulating the apartments. The Appellate Division decision and order was subject to a motion for leave to appeal, which was granted on April 24, 2018. There can be no assurance as to the outcome of the appeal. Due to the inherent uncertainty and unpredictability of litigation, we cannot determine at this time with any specificity the Company’s potential liability.

In addition to the above, the Company is subject to certain legal proceedings and claims arising in connection with its business. Management believes, based in part upon consultation with legal counsel, that the ultimate resolution of all such claims will not have a material adverse effect on the Company’s consolidated results of operations, financial position, or cash flows.

Commitments

The Company is obligated to provide parking availability through August 2020 under a lease with a tenant at the 250 Livingston Street property; the current cost to the Company is approximately \$240 per year.

Concentrations

The Company’s properties are located in the Boroughs of Manhattan and Brooklyn in New York City, which exposes the Company to greater economic risks than if it owned a more geographically dispersed portfolio.

The breakdown between commercial and residential revenue is as follows:

	Commercial	Residential	Total
Three months ended June 30, 2018	25%	75%	100%
Three months ended June 30, 2017	26%	74%	100%
Six months ended June 30, 2018	25%	75%	100%
Six months ended June 30, 2017	26%	74%	100%

11. Related-Party Transactions

The Company recorded office and overhead expenses pertaining to a related company in general and administrative expense of \$86 and \$134 for the three months ended June 30, 2018 and 2017, respectively, and \$175 and \$232 for the six months ended June 30, 2018 and 2017, respectively.

The Company paid legal and advisory fees to firms in which two of our directors were principals or partners of \$0 and \$639 for the three months ended June 30, 2018 and 2017, respectively, and \$1,880 and \$699 for the six months ended June 30, 2018 and 2017, respectively.

12. Segment Reporting

The Company has classified its reporting segments into commercial and residential rental properties. The commercial reporting segment includes the 141 Livingston Street property and portions of the 250 Livingston Street, Tribeca House and Aspen properties. The residential reporting segment includes the Flatbush Gardens property, the 107 Columbia Heights property, the 10 West 65th Street property and portions of the 250 Livingston Street, Tribeca House and Aspen properties.

The Company's income from operations by segment for the three and six months ended June 30, 2018 and 2017, is as follows:

Three months ended June 30, 2018	Commercial	Residential	Total
Rental revenues	\$5,375	\$19,670	\$25,045
Tenant recoveries	1,200	—	1,200
Garage and other revenue income	229	826	1,055
Total revenues	6,804	20,496	27,300
Property operating expenses	1,040	5,541	6,581
Real estate taxes and insurance	1,111	4,251	5,362
General and administrative	218	2,388	2,606
Depreciation and amortization	896	3,539	4,435
Total operating expenses	3,265	15,719	18,984
Income from operations	\$3,539	\$4,777	\$8,316

Three months ended June 30, 2017	Commercial	Residential	Total
Rental revenues	\$5,471	\$18,079	\$23,550
Tenant recoveries	1,017	—	1,017
Garage and other revenue income	215	576	791
Total revenues	6,703	18,655	25,358
Property operating expenses	1,026	5,538	6,564
Real estate taxes and insurance	1,066	3,751	4,817
General and administrative	208	2,380	2,588
Acquisition costs	—	6	6
Depreciation and amortization	835	3,228	4,063
Total operating expenses	3,135	14,903	18,038
Income from operations	\$3,568	\$3,752	\$7,320

Six months ended June 30, 2018	Commercial	Residential	Total
Rental revenues	\$10,752	\$38,968	\$49,720
Tenant recoveries	2,374	—	2,374
Garage and other revenue income	459	1,615	2,074
Total revenues	13,585	40,583	54,168
Property operating expenses	2,250	11,587	13,837
Real estate taxes and insurance	2,217	8,493	10,710
General and administrative	536	5,208	5,744
Depreciation and amortization	1,771	7,260	9,031
Total operating expenses	6,774	32,548	39,322
Income from operations	\$6,811	\$8,035	\$14,846

Six months ended June 30, 2017	Commercial	Residential	Total
Rental revenues	\$10,942	\$36,116	\$47,058
Tenant recoveries	2,061	—	2,061
Garage and other revenue income	427	1,075	1,502
Total revenues	13,430	37,191	50,621
Property operating expenses	2,107	11,562	13,669
Real estate taxes and insurance	2,123	7,346	9,469
General and administrative	396	4,388	4,784
Acquisition costs	—	27	27
Depreciation and amortization	1,603	6,395	7,998
Total operating expenses	6,229	29,718	35,947
Income from operations	\$7,201	\$7,473	\$14,674

The Company's total assets by segment are as follows, as of:

	Commercial	Residential	Total
June 30, 2018	\$212,828	\$855,366	\$1,068,194
December 31, 2017	222,288	829,797	1,052,085

The Company's interest expense by segment for the three and six months ended June 30, 2018 and 2017, is as follows:

	Commercial	Residential	Total
<u>Three months ended June 30,</u>			
2018	\$1,707	\$6,301	\$8,008
2017	1,942	6,989	8,931
<u>Six months ended June 30,</u>			
2018	\$3,528	\$13,023	\$16,551
2017	3,823	13,760	17,583

The Company's capital expenditures by segment for the three and six months ended June 30, 2018 and 2017, are as follows:

	Commercial	Residential	Total
<u>Three months ended June 30,</u>			
2018	\$809	\$9,132	\$9,941
2017	2,002	4,035	6,037
<u>Six months ended June 30,</u>			
2018	\$1,047	\$21,463	\$22,510
2017	3,013	6,126	9,139

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

You should read the following discussion of our financial condition and results of operations in conjunction with the more detailed information set forth under the caption, "Cautionary Note Concerning Forward-Looking Statements," and in our financial statements and the related notes thereto appearing elsewhere in this Quarterly Report on Form 10-Q.

Overview of Our Company

We are a self-administered and self-managed real estate company that acquires, owns, manages, operates and repositions multifamily residential and commercial properties in the New York metropolitan area, with a current portfolio in Manhattan and Brooklyn. Our primary focus is to own, manage and operate our portfolio and to acquire and reposition additional multifamily residential and commercial properties in the New York metropolitan area. The Company has been organized and operates in conformity with the requirements for qualification and taxation as a real estate investment trust ("REIT") under the U.S. federal income tax law and elected to be treated as a REIT commencing with the taxable year ended December 31, 2015.

Clipper Realty Inc. (the "Company" or "we") was incorporated on July 7, 2015. On August 3, 2015, we closed a private offering of shares of our common stock, in which we raised net proceeds of approximately \$130.2 million. In connection with the private offering, we consummated a series of investment and other formation transactions that were designed, among other things, to enable us to qualify as a REIT for U.S. federal income tax purposes.

In February 2017, the Company sold 6,390,149 primary shares of common stock (including the exercise of the over-allotment option, which closed on March 10, 2017) to investors in an initial public offering ("IPO") at \$13.50 per share. The proceeds, net of offering costs, were approximately \$78.7 million. The Company contributed the IPO proceeds to the Operating Partnership in exchange for units in the Operating Partnership.

On May 9, 2017, the Company completed the purchase of 107 Columbia Heights, a 161-unit apartment community located in Brooklyn Heights, New York, for \$87.5 million.

On October 27, 2017, the Company completed the acquisition of an 82-unit residential property at 10 West 65th Street in Manhattan, New York, for \$79.0 million.

As of June 30, 2018, the Company owns:

- two neighboring residential/retail rental properties at 50 Murray Street and 53 Park Place in the Tribeca neighborhood of Manhattan;
- one residential property complex in the East Flatbush neighborhood of Brooklyn consisting of 59 buildings;
- two primarily commercial properties in Downtown Brooklyn (one of which includes 36 residential apartment units);
- one residential/retail rental property at 1955 1st Avenue in Manhattan;
- one residential rental property at 107 Columbia Heights in the Brooklyn Heights neighborhood of Brooklyn; and
- one residential rental property at 10 West 65th Street in the Upper West Side neighborhood of Manhattan.

These properties are located in the most densely populated major city in the United States, each with immediate access to mass transportation.

The Company is in active discussions with the City of New York regarding renewal of its commercial leases at the 250 Livingston Street property, which terminate in August 2020 and comprise approximately 294,000 square feet (since remeasured to approximately 353,000 square feet). The terms being discussed would increase the rent from the current blended \$27.71 per square foot to the low-to-mid \$40 per square foot range, which is similar to the terms currently in place for the approximate 30% of the commercial space in the building that was leased on January

1, 2017, and for the 141 Livingston Street property. Negotiations are underway and there can be no assurance or prediction of the final outcome of the negotiations.

Both the Flatbush Gardens and 107 Columbia Heights properties are located in newly designated qualified opportunity zones, in connection with the opportunity zone community development program offered through the Tax Cuts and Jobs Act of 2017. The federal program encourages private investment in low-income urban and rural communities. Opportunity zones are designed to spur economic development and job creation in specified communities by providing tax benefits to investors, including the potential deferral and exclusion of prior capital gains from taxable income.

The operations of Clipper Realty, Inc., and its consolidated subsidiaries are carried on primarily through the Operating Partnership. The Company has elected to be taxed as a REIT under Sections 856 through 860 of the Internal Revenue Code. The Company is the sole general partner of the Operating Partnership and the Operating Partnership is the sole managing member of the LLCs that comprised the Predecessor.

At June 30, 2018, the Company's interest, through the Operating Partnership, in the LLCs that own the properties generally entitles it to 40.4% of the aggregate cash distributions from, and the profits and losses of, the LLCs.

Results of Operations

Our focus throughout 2017 and year-to-date 2018 has been to manage our properties to optimize revenues and control costs, while continuing to renovate and reposition certain properties. The discussion below highlights the specific properties contributing to the changes in the results of operations, and focuses on the properties that the Company owned for the full period in each comparison.

Income Statement for the Three Months Ended June 30, 2018 and 2017 (in thousands)

	2018	Less: 10 West 65 th Street	2018 excluding 10 West 65 th Street	2017	Increase (decrease)	%
Revenues						
Residential rental revenue	\$19,670	\$760	\$18,910	\$18,079	\$831	4.6%
Commercial rental revenue	5,375	—	5,375	5,471	(96)	(1.8)%
Tenant recoveries	1,200	—	1,200	1,017	183	18.0%
Garage and other income	1,055	4	1,051	791	260	32.8%
Total revenues	27,300	764	26,536	25,358	1,178	4.6%
Operating Expenses						
Property operating expenses	6,581	85	6,496	6,564	(68)	(1.0)%
Real estate taxes and insurance	5,362	202	5,160	4,817	343	7.1%
General and administrative	2,606	53	2,553	2,588	(35)	(1.4)%
Acquisition costs	—	—	—	6	(6)	(100.0)%
Depreciation and amortization	4,435	269	4,166	4,063	103	2.5%
Total operating expenses	18,984	609	18,375	18,038	337	1.9%
Income from operations	8,316	155	8,161	7,320	841	11.5%
Interest expense, net	(8,008)	(312)	(7,696)	(8,931)	(1,235)	(13.8)%
Net income (loss)	\$308	\$(157)	\$465	\$(1,611)	\$2,076	128.8%

Revenue. Residential rental revenue, excluding 10 West 65th Street, increased from \$18,079 for the three months ended June 30, 2017, to \$18,910 for the three months ended June 30, 2018, primarily due to increases in rental rates and leased occupancy at the Flatbush Gardens and Tribeca House properties. Base rent per square foot increased at the Flatbush Gardens property from \$21.59 (97.0% leased occupancy) at June 30, 2017, to \$22.89 (97.5% leased occupancy) at June 30, 2018. Base rent per square foot increased at the Tribeca House property from \$67.13 (94.7% leased occupancy) at June 30, 2017, to \$67.79 (97.6% leased occupancy) at June 30, 2018.

Commercial rental revenue was essentially flat for the three months ended June 30, 2018, compared to the three months ended June 30, 2017.

Tenant recoveries increased from \$1,017 for the three months ended June 30, 2017, to \$1,200 for the three months ended June 30, 2018, primarily due to higher billable expenses.

Garage and other income, excluding 10 West 65th Street, increased from \$791 for the three months ended June 30, 2017, to \$1,051 for the three months ended June 30, 2018. The increase was primarily due to an increase in air conditioning charges at the Flatbush Gardens property.

Property operating expense. Property operating expenses include property-level costs including compensation costs for property-level personnel, repairs and maintenance, supplies, utilities and landscaping. Property operating expenses, excluding 10 West 65th Street, were essentially flat for the three months ended June 30, 2018, compared to the three months ended June 30, 2017, primarily reflecting seasonally higher gas and oil heating costs and higher leasing commissions, offset by a reduction in the provision for bad debts (as the result of an improvement in residential rent collection experience at the Flatbush Gardens property) and lower property-level personnel costs.

Real estate taxes and insurance expense. Real estate taxes and insurance expenses, excluding 10 West 65th Street, increased from \$4,817 for the three months ended June 30, 2017, to \$5,160 for the three months ended June 30, 2018, primarily due to increased taxes at our Flatbush Gardens and Tribeca House properties due in part to the cessation of real estate tax abatements.

General and administrative expense. General and administrative expenses, excluding 10 West 65th Street, were essentially flat for the three months ended June 30, 2018, compared to the three months ended June 30, 2017.

Depreciation and amortization. Depreciation and amortization expense, excluding 10 West 65th Street, increased from \$4,063 for the three months ended June 30, 2017, to \$4,166 for the three months ended June 30, 2018, due to additions to real estate.

Interest expense, net. Interest expense, net, excluding 10 West 65th Street, was \$8,931 for the three months ended June 30, 2017, and \$7,696 for the three months ended June 30, 2018. The decrease resulted from lower rates obtained in refinancing the Tribeca House and Flatbush Gardens properties in February 2018 and lower amortization of loan costs. Interest expense, excluding 10 West 65th Street, included amortization of loan costs and changes in fair value of interest rate caps of \$199 and \$913 for the three months ended June 30, 2018 and 2017, respectively.

Net income (loss). As a result of the foregoing, net income, excluding 10 West 65th Street, increased from a net loss of \$1,611 for the three months ended June 30, 2017, to net income of \$465 for the three months ended June 30, 2018.

Income Statement for the Six Months Ended June 30, 2018 and 2017 (in thousands)

	2018	2018		2017	Increase (decrease)	%
		Less: 10 West 65 th Street	excluding 10 West 65 th Street			
Revenues						
Residential rental revenue	\$38,968	\$1,509	\$37,459	\$36,116	\$1,343	3.7%
Commercial rental revenue	10,752	—	10,752	10,942	(190)	(1.7)%
Tenant recoveries	2,374	—	2,374	2,061	313	15.2%
Garage and other income	2,074	7	2,067	1,502	565	37.6%
Total revenues	54,168	1,516	52,652	50,621	2,031	4.0%
Operating Expenses						
Property operating expenses	13,837	233	13,604	13,669	(65)	(0.5)%
Real estate taxes and insurance	10,710	404	10,306	9,469	837	8.8%
General and administrative	5,744	124	5,620	4,784	836	17.5%
Acquisition costs	—	—	—	27	(27)	(100.0)%
Depreciation and amortization	9,031	778	8,253	7,998	255	3.2%
Total operating expenses	39,322	1,539	37,783	35,947	1,836	5.1%
Income from operations	14,846	(23)	14,869	14,674	195	1.3%
Interest expense, net	(16,551)	(623)	(15,928)	(17,583)	(1,655)	(9.4)%
Loss on extinguishment of debt	(6,981)	—	(6,981)	—	6,981	NM
Net loss	\$(8,686)	\$(646)	\$(8,040)	\$(2,909)	\$(5,131)	(176.4)%

Revenue. Residential rental revenue, excluding 10 West 65th Street, increased from \$36,116 for the six months ended June 30, 2017, to \$37,459 for the six months ended June 30, 2018, primarily due to increases in rental rates and leased occupancy at the Flatbush Gardens and Tribeca House properties. Base rent per square foot increased at the Flatbush Gardens property from \$21.59 (97.0% leased occupancy) at June 30, 2017, to \$22.89 (97.5% leased occupancy) at June 30, 2018. Base rent per square foot increased at the Tribeca House property from \$67.13 (94.7% leased occupancy) at June 30, 2017, to \$67.79 (97.6% leased occupancy) at June 30, 2018.

Commercial rental revenue was essentially flat for the six months ended June 30, 2018, compared to the six months ended June 30, 2017.

Tenant recoveries increased from \$2,061 for the six months ended June 30, 2017, to \$2,374 for the six months ended June 30, 2018, primarily due to higher billable expenses.

Garage and other income, excluding 10 West 65th Street, increased from \$1,502 for the six months ended June 30, 2017, to \$2,067 for the six months ended June 30, 2018. The increase was primarily due to an increase in air conditioning charges at the Flatbush Gardens property.

Property operating expense. Property operating expenses include property-level costs including compensation costs for property-level personnel, repairs and maintenance, supplies, utilities and landscaping. Property operating expenses, excluding 10 West 65th Street, were essentially flat for the six months ended June 30, 2018, compared to the six months ended June 30, 2017, primarily reflecting seasonally higher gas and oil heating costs, higher leasing commissions, higher repairs and maintenance costs and higher supplies costs, offset by a reduction in the provision for bad debts (as the result of an improvement in residential rent collection experience at the Flatbush Gardens property) and lower property-level personnel costs.

Real estate taxes and insurance expense. Real estate taxes and insurance expenses, excluding 10 West 65th Street, increased from \$9,469 for the six months ended June 30, 2017, to \$10,306 for the six months ended June 30, 2018, primarily due to increased taxes at our Flatbush Gardens and Tribeca House properties due in part to the cessation of real estate tax abatements.

General and administrative expense. General and administrative expenses, excluding 10 West 65th Street, increased from \$4,784 for the six months ended June 30, 2017, to \$5,620 for the six months ended June 30, 2018, primarily due to executive cash bonuses and public company professional fees.

Depreciation and amortization. Depreciation and amortization expense, excluding 10 West 65th Street, increased from \$7,998 for the six months ended June 30, 2017, to \$8,253 for the six months ended June 30, 2018, due to additions to real estate.

Interest expense, net. Interest expense, net, excluding 10 West 65th Street, was \$17,583 for the six months ended June 30, 2017, and \$15,928 for the six months ended June 30, 2018. The decrease resulted from lower rates obtained in refinancing the Tribeca House and Flatbush Gardens properties in February 2018 and lower amortization of loan costs. Interest expense, excluding 10 West 65th Street, included amortization of loan costs and changes in fair value of interest rate caps of \$471 and \$1,771 for the six months ended June 30, 2018 and 2017, respectively.

Loss on extinguishment of debt. Loss on extinguishment of debt related to the repayment of the Flatbush Gardens and Tribeca House loans in February 2018. The amount included charges for early extinguishment of the debt and the write-off of unamortized debt costs.

Net loss. As a result of the foregoing, net loss, excluding 10 West 65th Street, increased from \$2,909 for the six months ended June 30, 2017, to \$8,040 for the six months ended June 30, 2018.

Liquidity and Capital Resources

As of June 30, 2018, we had \$872.6 million of indebtedness (net of unamortized issuance costs) secured by our properties, and \$15.8 million of cash. As described in Note 7 of the accompanying “Notes to Consolidated Financial Statements,” the Company refinanced its outstanding Flatbush Gardens and Tribeca House loans on February 21, 2018. As a result, we do not have any debt maturing in 2018. No assurance can be given that we will be able to refinance any of our outstanding indebtedness in the future on favorable terms or at all.

In February 2017, we completed an IPO which provided net proceeds of approximately \$78.7 million,

including the exercise of the underwriters' over-allotment option in March 2017, and after deducting underwriting discounts and commissions and other offering expenses paid by us.

As a REIT, we are required to distribute at least 90% of our REIT taxable income, computed without regard to the dividends paid deduction and excluding net capital gains, to stockholders on an annual basis. We expect that these needs will be met from cash generated from operations and other sources, including proceeds from secured mortgages and unsecured indebtedness, proceeds from additional equity issuances and cash generated from the sale of property.

Short-Term and Long-Term Liquidity Needs

Our short-term liquidity needs will primarily be to fund operating expenses, recurring capital expenditures, property taxes and insurance, interest and scheduled debt principal payments, general and administrative expenses and distributions to stockholders and unit holders. We generally expect to meet our short-term liquidity requirements through net cash provided by operations, and we believe we will have sufficient resources to meet our short-term liquidity requirements.

Our principal long-term liquidity needs will primarily be to fund additional property acquisitions, major renovation and upgrading projects, and debt payments and retirements at maturity. We do not expect that net cash provided by operations will be sufficient to meet all of these long-term liquidity needs. We anticipate meeting our long-term liquidity requirements by using cash as an interim measure and funds from public and private equity offerings and long-term secured and unsecured debt offerings.

We believe that as a publicly traded REIT, we will have access to multiple sources of capital to fund our long-term liquidity requirements. These sources include the incurrence of additional debt and the issuance of additional equity. However, we cannot provide assurance that this will be the case. Our ability to secure additional debt will depend on a number of factors, including our cash flow from operations, our degree of leverage, the value of our unencumbered assets and borrowing restrictions that may be imposed. Our ability to access the equity capital markets will depend on a number of factors as well, including general market conditions for REITs and market perceptions about our company.

We believe that our current cash flows from operations, coupled with additional mortgage debt, will be sufficient to allow us to continue operations, satisfy our contractual obligations and make distributions to our stockholders and the members of our LLC subsidiaries.

Distributions

In order to qualify as a REIT for Federal income tax purposes, we must currently distribute at least 90% of our taxable income to our shareholders. During the three and six months ended June 30, 2018, we paid dividends and distributions on our common shares, Class B LLC units and LTIP units totaling \$4.3 million and \$8.5 million, respectively.

Cash Flows for the Six Months Ended June 30, 2018 and 2017 (in thousands)

	Six Months Ended	
	June 30,	
	2018	2017
Operating activities	\$14,979	\$4,328
Investing activities	(18,861)	(98,308)
Financing activities	11,736	124,917

Cash flows provided by (used in) operating activities, investing activities and financing activities for the six months ended June 30, 2018 and 2017, are as follows:

Net cash flow provided by operating activities was \$14,979 for the six months ended June 30, 2018, compared to \$4,328 for the six months ended June 30, 2017. The net increase during the 2018 period reflects an increase of approximately \$10,123 of cash generated by operating assets and liabilities (including reductions in tenant and other

receivables and restricted cash), plus an increase of approximately \$528 of cash flow from operating results.

Net cash used in investing activities was \$18,861 for the six months ended June 30, 2018, compared to \$98,308 for the six months ended June 30, 2017. We spent approximately \$19,246 and \$8,578 on capital projects for the six months ended June 30, 2018 and 2017, respectively. For the six months ended June 30, 2018, we received approximately \$385 of net proceeds from the sale of interest rate caps. For the six months ended June 30, 2017, we funded approximately \$87,600 for the acquisition of the 107 Columbia Heights property and an approximate \$2,144 acquisition deposit for the 10 West 65th Street property.

Net cash provided by financing activities was \$11,736 and \$124,917 for the six months ended June 30, 2018 and 2017, respectively. Cash was primarily provided in the six months ended June 30, 2018, by proceeds from new loans on the Flatbush Gardens and Tribeca House properties (\$606,000), offset by repayment of existing loans on the Flatbush Gardens and Tribeca House properties (approximately \$578,000), and loan issuance and extinguishment costs (\$8,338); and in the six months ended June 30, 2017, by the IPO completed in February and March (\$78,811) and net proceeds from the loan used in the 107 Columbia Heights acquisition (approximately \$55,000). The Company paid distributions of \$8,515 and \$8,056 in the six months ended June 30, 2018 and 2017, respectively.

Income Taxes

No provision has been made for income taxes since all of the Company's operations are held in pass-through entities and accordingly the income or loss of the Company is included in the individual income tax returns of the partners or members.

We elected to be treated as a REIT for U.S. federal income tax purposes, beginning with our first taxable three months ended March 31, 2015. As a REIT, we generally will not be subject to federal income tax on income that we distribute to our stockholders. 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 tax rates. We believe that we are organized and operate in a manner that will enable us to qualify and be taxed as a REIT and we intend to continue to operate so as to satisfy the requirements for qualification as a REIT for federal income tax purposes.

Inflation

Inflation in the United States has been relatively low in recent years and did not have a significant impact on the results of operations for the Company's business for the periods shown in the consolidated financial statements. We do not believe that inflation currently poses a material risk to the Company. The leases at our residential rental properties, which comprise approximately 72% of our revenue, are short-term in nature. Our longer-term commercial and retail leases would generally allow us to recover some increased costs in the event of significant inflation.

Although the impact of inflation has been relatively insignificant in recent years, it does remain a factor in the United States economy and could increase the cost of acquiring or replacing properties in the future.

Off-Balance Sheet Arrangements

As of June 30, 2018, we do not have any off-balance sheet arrangements that have had or are reasonably likely to have a material effect on our financial condition, revenues or expenses, results of operations, liquidity, capital resources or capital expenditures.

Non-GAAP Financial Measures

In this Quarterly Report on Form 10-Q, we disclose and discuss funds from operations ("FFO"), adjusted funds from operations ("AFFO"), adjusted earnings before interest, income taxes, depreciation and amortization ("Adjusted EBITDA") and net operating income ("NOI"), all of which meet the definition of "non-GAAP financial measure" set forth in Item 10(e) of Regulation S-K promulgated by the SEC.

While management and the investment community in general believe that presentation of these measures provides useful information to investors, neither FFO, AFFO, Adjusted EBITDA, nor NOI should be considered as

an alternative to net income or income from operations as an indication of our performance. We believe that to understand our performance further, FFO, AFFO, Adjusted EBITDA, and NOI should be compared with our reported net income or income from operations and considered in addition to cash flows computed in accordance with GAAP, as presented in our consolidated financial statements.

Funds From Operations and Adjusted Funds From Operations

FFO is defined by the National Association of Real Estate Investment Trusts (“NAREIT”) as net income (computed in accordance with GAAP), excluding gains (or losses) from sales of property and impairment adjustments, plus depreciation and amortization, and after adjustments for unconsolidated partnerships and joint ventures. Our calculation of FFO is consistent with FFO as defined by NAREIT.

AFFO is defined by us as FFO excluding amortization of identifiable intangibles incurred in property acquisitions, straight-line rent adjustments to revenue from long-term leases, amortization costs incurred in originating debt, interest rate cap mark-to-market, amortization of non-cash equity compensation, acquisition costs and loss on extinguishment of debt, less recurring capital expenditures.

Historical cost accounting for real estate assets implicitly assumes that the value of real estate assets diminishes predictably over time. In fact, real estate values have historically risen or fallen with market conditions. FFO is intended to be a standard supplemental measure of operating performance that excludes historical cost depreciation and valuation adjustments from net income. We consider FFO useful in evaluating potential property acquisitions and measuring operating performance. We further consider AFFO useful in determining funds available for payment of distributions. Neither FFO nor AFFO represent net income or cash flows from operations computed in accordance with GAAP. You should not consider FFO and AFFO to be alternatives to net income as reliable measures of our operating performance; nor should you consider FFO and AFFO to be alternatives to cash flows from operating, investing or financing activities (computed in accordance with GAAP) as measures of liquidity.

Neither FFO nor AFFO measure whether cash flow is sufficient to fund all of our cash needs, including principal amortization, capital improvements and distributions to stockholders. FFO and AFFO do not represent cash flows from operating, investing or financing activities computed in accordance with GAAP. Further, FFO and AFFO as disclosed by other REITs might not be comparable to our calculations of FFO and AFFO.

The following table sets forth a reconciliation of FFO and AFFO for the periods presented to net income (loss) before allocation to non-controlling interests, computed in accordance with GAAP (amounts in thousands):

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2018	2017	2018	2017
FFO				
Net income (loss)	\$308	\$(1,611)	\$(8,686)	\$(2,909)
Real estate depreciation and amortization	4,435	4,063	9,031	7,998
FFO	\$4,743	\$2,452	\$345	\$5,089
AFFO				
FFO	\$4,743	\$2,452	\$345	\$5,089
Amortization of real estate tax intangible	118	391	236	783
Amortization of above- and below-market leases	(480)	(432)	(959)	(866)
Straight-line rent adjustments	257	78	513	156
Amortization of debt origination costs	231	721	752	1,442
Interest rate cap mark-to-market	(10)	192	(237)	329
Amortization of LTIP awards	691	834	1,259	1,429
Acquisition costs	—	6	—	27
Loss on extinguishment of debt	—	—	6,981	—
Recurring capital spending	(101)	(141)	(242)	(277)
AFFO	\$5,449	\$4,101	\$8,648	\$8,112

Adjusted Earnings Before Interest, Income Taxes, Depreciation and Amortization

We believe that Adjusted EBITDA is a useful measure of our operating performance. We define Adjusted EBITDA as net income (loss) before allocation to non-controlling interests, plus real estate depreciation and amortization, amortization of identifiable intangibles, straight-line rent adjustments to revenue from long-term leases, amortization of non-cash equity compensation, interest expense (net), acquisition costs and loss on extinguishment of debt.

We believe that this measure provides an operating perspective not immediately apparent from GAAP income from operations or net income. We consider Adjusted EBITDA to be a meaningful financial measure of our core operating performance.

However, Adjusted EBITDA should only be used as an alternative measure of our financial performance. Further, other REITs may use different methodologies for calculating Adjusted EBITDA, and accordingly, our Adjusted EBITDA may not be comparable to that of other REITs.

The following table sets forth a reconciliation of Adjusted EBITDA for the periods presented to net income (loss) before allocation to non-controlling interests, computed in accordance with GAAP (amounts in thousands):

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2018	2017	2018	2017
Adjusted EBITDA				
Net income (loss)	\$308	\$(1,611)	\$(8,686)	\$(2,909)
Real estate depreciation and amortization	4,435	4,063	9,031	7,998
Amortization of real estate tax intangible	118	391	236	783
Amortization of above- and below-market leases	(480)	(432)	(959)	(866)
Straight-line rent adjustments	257	78	513	156
Amortization of LTIP awards	691	834	1,259	1,429
Interest expense, net	8,008	8,931	16,551	17,582
Acquisition costs	—	6	—	27
Loss on extinguishment of debt	—	—	6,981	—
Adjusted EBITDA	<u>\$13,337</u>	<u>\$12,260</u>	<u>\$24,926</u>	<u>\$24,200</u>

Net Operating Income

We believe that NOI is a useful measure of our operating performance. We define NOI as income from operations plus real estate depreciation and amortization, general and administrative expenses, acquisition costs, amortization of identifiable intangibles and straight-line rent adjustments to revenue from long-term leases. We believe that this measure is widely recognized and provides an operating perspective not immediately apparent from GAAP operating income or net income. We use NOI to evaluate our performance because NOI allows us to evaluate the operating performance of our company by measuring the core operations of property performance and capturing trends in rental housing and property operating expenses. NOI is also a widely used metric in valuation of properties.

However, NOI should only be used as an alternative measure of our financial performance. Further, other REITs may use different methodologies for calculating NOI, and accordingly, our NOI may not be comparable to that of other REITs.

The following table sets forth a reconciliation of NOI for the periods presented to income from operations, computed in accordance with GAAP (amounts in thousands):

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2018	2017	2018	2017
NOI				
Income from operations	\$8,316	\$7,320	\$14,846	\$14,674
Real estate depreciation and amortization	4,435	4,063	9,031	7,998
General and administrative expenses	2,606	2,588	5,744	4,784
Acquisition costs	—	6	—	27
Amortization of real estate tax intangible	118	391	236	783
Amortization of above- and below-market leases	(480)	(432)	(959)	(866)
Straight-line rent adjustments	257	78	513	156
NOI	\$15,252	\$14,014	\$29,411	\$27,556

Critical Accounting Policies

Management’s discussion and analysis of financial condition and results of operations is based upon our consolidated financial statements, which have been prepared in accordance with GAAP. The preparation of these consolidated financial statements requires management to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses. Management bases its estimates on historical experience and assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying value of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. We believe that there have been no material changes to the items that we disclosed as our critical accounting policies under Item 7, “Management’s Discussion and Analysis of Financial Condition and Results of Operations,” in our Form 10-K for the year ended December 31, 2017, as amended.

Recent Accounting Pronouncements

In July 2018, FASB issued ASU 2018-11, “Leases (Topic 842): Targeted Improvements,” which amended ASC 842 to provide a practical expedient to lessors to elect to not separate nonlease components from the associated leases. The Company is currently assessing the impact this guidance will have on its consolidated financial statements.

In July 2018, FASB issued ASU 2018-10, “Codification Improvements to Topic 842, Leases.” These amendments provide clarifications and corrections to ASU 2016-02, “Leases (Topic 842).” The Company is currently assessing the impact this guidance will have on its consolidated financial statements.

In July 2018, FASB issued ASU 2018-09, “Codification Improvements.” These amendments provide clarifications and corrections to certain ASC subtopics including the following: 470-50 (Debt – Modifications and Extinguishments), 480-10 (Distinguishing Liabilities from Equity – Overall), 718-740 (Compensation – Stock Compensation – Income Taxes), 805-740 (Business Combinations – Income Taxes), 815-10 (Derivatives and Hedging – Overall) and 820-10 (Fair Value Measurement – Overall). The Company is currently assessing the impact this guidance will have on its consolidated financial statements.

In June 2018, FASB issued ASU 2018-07, “Compensation – Stock Compensation (Topic 718): Improvements to Nonemployee Share-Based Payment Accounting.” These amendments provide specific guidance for transactions for acquiring goods and services from nonemployees and specify that Topic 718 applies to all share-based payment transactions in which a grantor acquires goods or services to be used or consumed in a grantor’s own operations by issuing share-based payment awards. The amendments also clarify that Topic 718 does not apply to share-based payments used to effectively provide (i) financing to the issuer or (ii) awards granted in conjunction with selling goods or services to customers as part of a contract accounted for under Topic 606, “Revenue from Contracts with Customers.” This guidance is effective for fiscal years beginning after December 15, 2018, and interim periods beginning after December 15, 2020. Early adoption is permitted but not earlier than the adoption of Topic 606. The Company does not believe that this guidance will have a material effect on its consolidated financial statements as it

has not historically issued share-based payments in exchange for goods or services to be consumed within its operations.

In May 2017, FASB issued ASU 2017-09, “Compensation – Stock Compensation (Topic 718) Scope of Modification Accounting.” ASU 2017-09 clarifies Topic 718 such that an entity must apply modification accounting to changes in the terms or conditions of a share-based payment award *unless* all of the following criteria are met:

1. The fair value of the modified award is the same as the fair value of the original award immediately before the modification. The standard indicates that if the modification does not affect any of the inputs to the valuation technique used to value the award, the entity is not required to estimate the value immediately before and after the modification.
2. The vesting conditions of the modified award are the same as the vesting conditions of the original award immediately before the modification.
3. The classification of the modified award as an equity instrument or a liability instrument is the same as the classification of the original award immediately before the modification.

The amendments are effective for all entities for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The adoption of ASU 2017-09 did not have a material impact on our consolidated financial statements.

In February 2017, FASB issued ASU 2017-05, “Other Income-Gains and Losses from the Derecognition of Nonfinancial Assets (Subtopic 610-20),” to add guidance for partial sales of nonfinancial assets, including partial sales of real estate. Historically, U.S. GAAP contained several different accounting models to evaluate whether the transfer of certain assets qualified for sale treatment. ASU 2017-05 reduces the number of potential accounting models that might apply and clarifies which model does apply in various circumstances. ASU 2017-05 is effective for public companies and for emerging growth companies for annual reporting periods beginning after December 15, 2017 and 2018, respectively, including interim reporting periods beginning after December 15, 2017 and December 15, 2019, respectively. The adoption of ASU 2017-05 is not expected to have a material impact on our consolidated financial statements.

In November 2016, the FASB issued ASU 2016-18 “Statement of Cash Flows (Topic 230) – Restricted Cash”. The ASU requires that a statement of cash flows explain the change during the period in the total of cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents. Therefore, amounts generally described as restricted cash and restricted cash equivalents should be included with cash and cash equivalents when reconciling the beginning-of-period and end-of-period total amounts shown on the statement of cash flows. The ASU does not provide a definition of restricted cash or restricted cash equivalents. The ASU is effective for public business entities, other than emerging growth companies, for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. For all other entities, the ASU is effective for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019. Early adoption is permitted, including adoption in an interim period. The Company is currently evaluating the effect that ASU No. 2016-18 will have on its consolidated financial statements.

In August 2016, the FASB issued ASU 2016-15, “Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments (A consensus of the Emerging Issues Task Force),” which provides specific guidance on eight cash flow classification issues and how to reduce diversity in how certain cash receipts and cash payments are presented and classified in the statement of cash flows. The effective date of this standard for public business entities, other than emerging growth companies, will be fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017. For all other entities, the ASU is effective for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019. Early adoption is permitted. The Company is currently evaluating the new guidance to determine the impact, if any, it will have on its consolidated financial statements.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Our future income, cash flows and fair value relevant to our financial instruments depends upon prevailing

market interest rates. Market risk refers to the risk of loss from adverse changes in market prices and interest rates. Based upon the nature of our operations, the principal market risk to which we are exposed is the risk related to interest rate fluctuations. Many factors, including governmental monetary and tax policies, domestic and international economic and political considerations, and other factors that are beyond our control, contribute to interest rate risk. To manage this risk, we purchased interest rate caps on the \$410.0 million of Tribeca House debt outstanding (prior to the Tribeca House debt refinancing on February 21, 2018) and the \$62.7 million of 107 Columbia Heights debt outstanding as of June 30, 2018, that would provide interest rate protection if one-month LIBOR exceeds 2.0% for the Tribeca House loans and 3.0% for the 107 Columbia Heights loans. On April 27, 2018, we terminated the Tribeca House interest rate cap.

A one percent change in interest rates on our \$62.7 million of variable rate debt as of June 30, 2018, would impact annual net income by approximately \$0.6 million.

The fair value of the Company's notes payable was approximately \$873.5 million and \$839.8 million as of June 30, 2018, and December 31, 2017, respectively.

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

Our management, with the participation of our Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO"), has evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act")), as of the end of the period covered by this Quarterly Report on Form 10-Q. Based on such evaluation, our CEO and CFO have concluded that as of June 30, 2018, our disclosure controls and procedures are designed at a reasonable assurance level and are effective to provide reasonable assurance that information we are required to disclose in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the SEC, and that such information is accumulated and communicated to our management, including our CEO and CFO, as appropriate, to allow timely decisions regarding required disclosure.

Changes in Internal Control

There were no changes in our internal control over financial reporting identified in management's evaluation pursuant to Rules 13a-15(d) or 15d-15(d) of the Exchange Act during the period covered by this Quarterly Report on Form 10-Q that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Limitations on Effectiveness of Controls and Procedures

In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives. In addition, the design of disclosure controls and procedures must reflect the fact that there are resource constraints and that management is required to apply judgment in evaluating the benefits of possible controls and procedures relative to their costs.

PART II – OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

On July 3, 2017, the New York Supreme Court (the "Court") ruled in favor of 41 present or former tenants of apartment units at the Company's buildings located at 50 Murray Street and 53 Park Place in Manhattan, New York, who brought an action against the Company alleging that they were subject to applicable rent stabilization laws with the result that rental payments charged by the Company exceeded amounts permitted under these laws because the buildings were receiving certain tax abatements under Real Property Tax Law 421-g. The Court also awarded the plaintiffs, their attorney's fees and costs. The Court declared that the plaintiff-tenants were subject to rent stabilization requirements and referred the matter to a special referee to determine the amount of rent over-charges, if any. On July 18, 2017, the Court stayed the above decision; the Company subsequently appealed the decision to

the Appellate Division, First Department. On January 18, 2018, the Appellate Division unanimously ruled in favor of the Company, holding that the Company acted properly in de-regulating the apartments. The Appellate Division decision and order was subject to a motion for leave to appeal, which was granted on April 24, 2018. There can be no assurance as to the outcome of the appeal. Due to the inherent uncertainty and unpredictability of litigation, we cannot determine at this time with any specificity the Company's potential liability.

In addition to the above, the Company is subject to certain legal proceedings and claims arising in connection with its business. Management believes, based in part upon consultation with legal counsel, that the ultimate resolution of all such claims will not have a material adverse effect on the Company's consolidated results of operations, financial position, or cash flows.

ITEM 1A. RISK FACTORS

The risk factors disclosed in the section entitled "Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2017, set forth information relating to various risks and uncertainties that could materially adversely affect our business, financial condition and operating results. Such risk factors continue to be relevant to an understanding of our business, financial condition and operating results. As of the date of this Quarterly Report on Form 10-Q, there have been no material changes with respect to such risk factors.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

Not applicable.

ITEM 4. MINE SAFETY DISCLOSURE

Not applicable.

ITEM 6. EXHIBITS

Exhibit Number	Description
*31.1	Rule 13a-14(a)/15d-14(a) Certification of Principal Executive Officer
*31.2	Rule 13a-14(a)/15d-14(a) Certification of Principal Financial Officer
*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
**101.INS	XBRL Instance Document.
**101.SCH	XBRL Taxonomy Extension Schema Document.
**101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document.
**101.LAB	XBRL Taxonomy Extension Label Linkbase Document.
**101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document.
**101.DEF	XBRL Taxonomy Extension Definition Linkbase Document

*Filed herewith

**Submitted electronically with the report

SIGNATURES

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

CLIPPER REALTY INC.

August 8, 2018

By: /s/ David Bistricher

David Bistricher

Co-Chairman and Chief Executive Officer