

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

**FORM 10-Q**

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

For the quarterly period ended September 30, 2011

OR

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

For the period from \_\_\_\_\_ to \_\_\_\_\_

**000-53673**

*(Commission file No.)*

**NetREIT, Inc.**

*(Exact name of registrant as specified in its charter)*

**Maryland**

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

**33-0841255**

*(I.R.S. employer identification no.)*

**1282 Pacific Oaks Place, Escondido, California 92029**

*(Address of principal executive offices)*

**(760) 471-8536**

*(Registrant's telephone number, including area code)*

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No .

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate website, 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, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (check one):

Large accelerated filer       Accelerated filer       Non-accelerated filer       Smaller Reporting Company   
(Do not check if a smaller reporting company)

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

At November 7, 2011, registrant had issued and outstanding 13,893,723 shares of its common stock, \$0.01 par value.

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Part I. FINANCIAL INFORMATION

Item 1. Financial Statements

**NetREIT, Inc. and Subsidiaries**  
**Condensed Consolidated Balance Sheets**

	<b>September 30</b>	<b>December 31</b>
	<b>2011</b>	<b>2010</b>
	<b>(Unaudited)</b>	<b></b>
	<u>          </u>	<u>          </u>
<b>ASSETS</b>		
Real estate assets, net	\$ 130,214,202	\$ 117,125,419
Lease intangibles, net	1,673,808	1,289,607
Land purchase option	1,370,000	1,370,000
Mortgages receivable and interest	1,032,818	920,216
Cash and cash equivalents	5,233,985	7,028,090
Restricted cash	690,204	299,042
Other real estate owned	2,178,532	2,178,532
Other assets, net	<u>4,507,232</u>	<u>3,105,056</u>
<b>TOTAL ASSETS</b>	<b><u>\$ 146,900,781</u></b>	<b><u>\$ 133,315,962</u></b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Liabilities:		
Mortgage notes payable	\$ 58,568,164	\$ 49,244,787
Accounts payable and accrued liabilities	3,796,512	3,499,118
Dividends payable	967,927	816,782
Total liabilities	<u>63,332,603</u>	<u>53,560,687</u>
Commitments and contingencies		
Shareholders' equity:		
Convertible series AA preferred stock, no par value, \$25 liquidating preference, shares authorized: 1,000,000; no shares issued and outstanding liquidating value of \$1,255,000	-	-
Common stock series A, \$0.01 par value, shares authorized: 100,000,000; 13,665,722 and 12,429,878 shares issued and outstanding at September 30, 2011 and December 31, 2010, respectively	136,657	124,298
Common stock series B, no par value, shares authorized: 1,000; no shares issued and outstanding	-	-
Additional paid-in capital	114,926,661	104,462,606
Dividends in excess of accumulated losses	<u>(38,624,313)</u>	<u>(31,304,801)</u>
Total shareholders' equity before noncontrolling interests	76,439,005	73,282,103
Noncontrolling interests	7,129,173	6,473,172
Total shareholders' equity	<u>83,568,178</u>	<u>79,755,275</u>
<b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b>	<b><u>\$ 146,900,781</u></b>	<b><u>\$ 133,315,962</u></b>

*See notes to condensed consolidated financial statements.*

**NetREIT, Inc. and Subsidiaries**  
**Condensed Consolidated Statements of Operations**  
**(Unaudited)**

	<i>Three Months Ended</i>		<i>Nine Months Ended</i>	
	<i>September 30,</i>		<i>September 30,</i>	
	<u>2011</u>	<u>2010</u>	<u>2011</u>	<u>2010</u>
Rental income	\$ 3,478,694	\$ 2,540,074	\$ 9,749,399	\$ 6,857,016
Fee and other income	124,098	78,538	477,846	234,831
	<u>3,602,792</u>	<u>2,618,612</u>	<u>10,227,245</u>	<u>7,091,847</u>
Costs and expenses:				
Rental operating costs	1,310,195	1,132,908	3,659,173	3,192,549
General and administrative	791,655	781,729	2,656,195	2,349,517
Depreciation and amortization	1,055,025	880,024	3,036,063	2,547,187
Total costs and expenses	<u>3,156,875</u>	<u>2,794,661</u>	<u>9,351,431</u>	<u>8,089,253</u>
Income (loss) from operations	445,917	(176,049)	875,814	(997,406)
Interest expense	(810,508)	(538,063)	(2,306,595)	(1,414,127)
Interest income	54,605	24,180	102,196	78,937
Loss on sale of real estate assets	(32,424)	-	(56,911)	-
Equity in earnings of real estate ventures	-	-	-	1,769
Net loss before noncontrolling interests	<u>(342,410)</u>	<u>(689,932)</u>	<u>(1,385,496)</u>	<u>(2,330,827)</u>
Income attributable to noncontrolling interests	75,187	60,896	301,305	155,391
Net loss	<u>(417,597)</u>	<u>(750,828)</u>	<u>(1,686,801)</u>	<u>(2,486,218)</u>
Preferred stock dividends	-	-	-	(34,447)
Net loss attributable to common shareholders	<u>\$ (417,597)</u>	<u>\$ (750,828)</u>	<u>\$ (1,686,801)</u>	<u>\$ (2,520,665)</u>
Loss per common share - basic and diluted:	<u>\$ (0.03)</u>	<u>\$ (0.07)</u>	<u>\$ (0.13)</u>	<u>\$ (0.23)</u>
Weighted average number of common shares outstanding	<u>13,409,931</u>	<u>11,509,003</u>	<u>13,027,349</u>	<u>10,964,396</u>

*See notes to condensed consolidated financial statements.*

**NetREIT, Inc. and Subsidiaries**  
**Condensed Consolidated Statements of Shareholders' Equity**  
**For the Nine Months Ended September 30, 2011**  
**(Unaudited)**

	<u>Common Stock</u> <u>Shares</u>	<u>Amount</u>	<u>Addi-</u> <u>tional Paid-in</u> <u>Capital</u>	<u>Dividends in</u> <u>Excess of</u> <u>Accum-</u> <u>ulated</u> <u>Losses</u>	<u>Total</u> <u>NetREIT,</u> <u>Inc Share-</u> <u>holders'</u> <u>Equity</u>	<u>Non-cont-</u> <u>rolling</u> <u>Interests</u>	<u>Total</u>
<b>Balance, December 31, 2010</b>	12,429,878	\$ 124,298	\$ 104,462,606	\$ (31,304,801)	\$ 73,282,103	\$ 6,473,172	\$ 79,755,275
Sale of common stock, net of selling costs	980,295	9,803	7,965,767	-	7,975,570	-	7,975,570
Repurchase of common stock	(39,004)	(390)	(301,685)	-	(302,075)	-	(302,075)
Repurchase of common stock-related parties	(9,560)	(95)	(82,425)	-	(82,520)	-	(82,520)
Net (loss) income				(1,686,801)	(1,686,801)	301,305	(1,385,496)
Dividends (declared)/reinvested	101,398	1,014	961,344	(1,930,285)	(967,927)	-	(967,927)
Dividends (paid)/reinvested	200,599	2,006	1,902,877	(3,702,426)	(1,797,543)	-	(1,797,543)
Issuance of vested restricted stock	2,116	21	18,177	-	18,198	-	18,198
Contributed capital less distributions to noncontrolling interests	-	-	-	-	-	354,696	354,696
<b>Balance, September 30, 2011</b>	<u>13,665,722</u>	<u>\$ 136,657</u>	<u>\$ 114,926,661</u>	<u>\$ (38,624,313)</u>	<u>\$ 76,439,005</u>	<u>\$ 7,129,173</u>	<u>\$ 83,568,178</u>

*See notes to condensed consolidated financial statements.*

**NetREIT, Inc. and Subsidiaries**  
**Condensed Consolidated Statements of Cash Flows**  
**(Unaudited)**

	<i>Nine Months Ended September 30 2011</i>	<i>Nine Months Ended September 30 2010</i>
Cash flows from operating activities:		
Net loss	\$ (1,686,801)	\$ (2,486,218)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	3,231,465	2,547,187
Stock compensation	312,540	243,405
Loss on sale of real estate assets	56,911	-
Bad debt expense	51,429	147,459
Equity in earnings of real estate ventures	-	(1,769)
Contributed capital less distributions of noncontrolling interests	354,696	(318,416)
Income attributable to noncontrolling interests	301,305	155,391
Other assets	(1,230,538)	(383,571)
Accounts payable and accrued liabilities	(15,145)	(12,760)
Net cash provided by (used in) operating activities	<u>1,375,862</u>	<u>(109,292)</u>
Cash flows from investing activities:		
Real estate acquisitions	(23,230,017)	(15,653,167)
Acquisition of company	-	(300,000)
Proceeds on sale of real estate assets	6,566,951	-
Deposits on potential acquisitions	(150,000)	-
Purchase of notes receivable net of repayments	(112,602)	-
Restricted cash	(391,162)	11,001
Net cash used in investing activities	<u>(17,316,830)</u>	<u>(15,942,166)</u>
Cash flows from financing activities:		
Proceeds from mortgage notes payable	17,501,890	7,925,000
Repayment of mortgage notes payable	(8,178,513)	(681,492)
Net proceeds from issuance of common stock	7,993,768	10,204,261
Repurchase of common stock	(302,075)	(62,934)
Repurchase of common stock - related parties	(82,520)	-
Redemption of preferred stock	-	(1,255,000)
Deferred stock issuance costs	(171,362)	(299,481)
Exercise of warrants	-	1,890
Exercise of stock options	-	2,000
Dividends paid	(2,614,325)	(2,084,884)
Net cash provided by financing activities	<u>14,146,863</u>	<u>13,749,360</u>
Additions to cash from consolidation of joint venture	<u>-</u>	<u>269,152</u>
Net decrease in cash and cash equivalents	(1,794,105)	(2,032,946)
Cash and cash equivalents:		
Beginning of period	7,028,090	9,298,523
End of period	<u>\$ 5,233,985</u>	<u>\$ 7,265,577</u>
Supplemental disclosure of cash flow information:		
Interest paid	<u>\$ 2,444,793</u>	<u>\$ 1,411,426</u>
Non-cash investing and financing activities:		
Reclassification of investment in real estate ventures to real estate assets	<u>\$ -</u>	<u>\$ 21,188,400</u>
Accrual of goodwill and related liability	<u>\$ -</u>	<u>\$ 1,032,000</u>

Reinvestment of cash dividend	<u>\$ 2,867,241</u>	<u>\$ 2,609,877</u>
Accrual of dividends payable	<u>\$ 967,927</u>	<u>\$ 751,228</u>
Change in par value for Maryland reincorporation	<u>\$ -</u>	<u>\$ 85,343,431</u>
Common Shares issued upon exercise of warrants	<u>\$ -</u>	<u>\$ 453,889</u>

*See notes to condensed consolidated financial statements.*

**NetREIT, Inc. and Subsidiaries**  
**Notes to Condensed Consolidated Financial Statements**

**1. ORGANIZATION AND BASIS OF PRESENTATION**

**Organization.** NetREIT (“we” or the “Company”) was incorporated in the State of California on January 28, 1999 for the purpose of investing in real estate properties. Effective August 4, 2010, NetREIT, a California Corporation, merged into NetREIT, Inc., a Maryland Corporation with NetREIT, Inc. becoming the surviving Corporation. As a result of the merger, NetREIT is now incorporated in the State of Maryland. As a California Corporation, the Company’s common stock had no par value. As a Maryland Corporation, the Company’s common stock now has a par value of \$0.01 per share which resulted in the transfer of \$85,343,431 from common stock to additional paid in capital. The Company qualifies and operates as a self-administered real estate investment trust (“REIT”) under the Internal Revenue Code of 1986, as amended, (the “Code”) and commenced operations with capital provided by its private placement offering of its equity securities in 1999.

The Company invests in a diverse portfolio of real estate assets. The primary types of properties the Company invests in include office, retail, self-storage and residential properties located in the western United States. As of September 30, 2011, the Company owned or had an equity interest in nine office buildings (“**Office Properties**”) which total approximately 543,000 rentable square feet, four retail shopping centers and a 7-Eleven property (“**Retail Properties**”) which total approximately 171,000 rentable square feet, five self-storage facilities (“**Self-Storage Properties**”) which total approximately 487,000 rentable square feet, one 39 unit apartment building and 79 model homes owned by six limited partnerships (“**Residential Properties**”).

The Company is the sole general partner of four limited partnerships: NetREIT 01 LP, NetREIT Palm Self-Storage LP, NetREIT Casa Grande LP and NetREIT Garden Gateway LP (the “**NetREIT Partnerships**”) and is the sole Managing Member in one limited liability company, Fontana Medical Plaza, LLC (“**FMP**”), each of which own income producing real estate investments.

In addition, the Company is a limited partner in six partnerships that purchase and leaseback model homes from home builders: Dubose Acquisition Partners II and Dubose Acquisition Partners III (“**DAP II**” and “**DAP III**”, respectively), “Dubose Model Home Income Fund #3, LTD.”, “Dubose Model Home Income Fund #4, LTD.”, “Dubose Model Home Income Fund #5, LTD.” (“**DMHI Fund #3**”, “**DMHI Fund #4**”, and “**DMHI Fund #5**”, respectively, and together the “**Income Funds**”), and NetREIT Dubose Model Home REIT, LP (“**Dubose REIT LP**”). The Company, through 100% ownership of Dubose Advisors LLC is also a general partner in Dubose Model Home Investors #201, LP. We refer to these partnerships as the “**Dubose Partnerships**”.

In March 2010, the Company purchased certain tangible and intangible personal property from Dubose Model Homes USA (“**DMHU**”), including rights to certain names, trademarks and trade secrets, title to certain business equipment, furnishings and related personal property. DMHU had used these assets in its previous business of purchasing model homes for investment in new residential housing tracts and initially leasing the model homes back to their developer. In addition, the Company also acquired DMHU’s rights under certain contracts, including contracts to provide management services to 19 limited partnerships sponsored by DMHU and for which a DMHU affiliate serves as sole general partner. We refer to these 19 partnerships as the “**Model Home Partnerships**”. These partnerships included DAP II and DAP III of which the Company was a 51% limited partner in each. The Company paid the owners of DMHU \$300,000 cash and agreed to issue up to 120,000 shares of the Company’s common stock, depending on the levels of production the Company achieves from its newly formed Model Home REIT over the next three years. The Company also agreed to employ three former DMHU employees and to pay certain obligations of DMHU, including its office lease which expired on September 30, 2010. As Mr. Dubose is a Company director and was the founder and former president and principal owner of DMHU and certain of its affiliates, this transaction was completed in compliance with the Company’s Board’s Related Party Transaction Policy. The transaction has been accounted for as a business combination. Management performed an analysis of intangible assets acquired with the assistance of an independent valuation specialist and it was determined that \$209,000 of the purchase price is attributable to customer relationships which will be amortized over 10 years. The Company also estimated a liability of \$1,032,000 associated with the 120,000 shares that it believes will be issued in the future. As a result of the acquisition, the total purchase price of \$1,332,000 was allocated between goodwill of \$1,123,000 and intangible assets of \$209,000. Also, as a result, the Company’s investment in DAP II and DAP III have been consolidated in the accompanying financial statements of NetREIT effective March 1, 2010.

In 2010, the Company formed a new subsidiary, NetREIT Advisors, LLC, (“**NetREIT Advisors**”), a wholly-owned Delaware limited liability company, and sponsored the formation of NetREIT Dubose Model Home REIT, Inc. (“**NetREIT Dubose**”), a Maryland corporation. NetREIT Dubose, a proposed REIT, invests in Model Homes it purchases from developers in transactions whereby the developer leases back the Model Home under a short term lease, typically one to three years in length. Upon expiration of the lease, NetREIT Dubose will seek to re-lease the Model Home until such time as it is able to sell the property. NetREIT Dubose owns substantially all of its assets and conducts its operations through an operating partnership called NetREIT Dubose REIT, LP, which is a wholly-owned Delaware limited partnership. NetREIT Advisors serves as advisor to NetREIT Dubose.

NetREIT Dubose is authorized to issue up to 25 million shares of \$0.01 shares of stock. Of these authorized shares, 20 million are common stock and 5 million are preferred stock. As of September 30, 2011, there were approximately 223,000 shares outstanding of which approximately 83,000 have been issued to parties other than NetREIT, Inc.

NetREIT Advisors also provides management services to the 19 Model Home Partnerships, pursuant to rights under the management contracts assigned to it by DMHU. For these services, NetREIT Advisors receives ongoing management fees and has the right to receive certain other fees when the respective partnership sells or otherwise disposes of its properties.

In September 2010, the Company commenced three tender offers for the purchase of outstanding limited partnerships units of the Income Funds. The offerings closed effective November 30, 2010. The Company acquired approximately 74% of Income Fund #3 for \$475,997 in cash and 39,827 shares for a total combined cost of \$874,263. The Company acquired approximately 71% of Income Fund #4 for \$343,074 in cash and 49,132 shares for a total combined cost of \$834,394. The Company acquired approximately 67% of Income Fund #5 for \$77,822 in cash and 23,931 shares for a total combined cost of \$317,136. As a result of the Company acquiring control of these three limited partnerships, their financial statements have been included in the consolidated financial statements of the Company beginning December 31, 2010, including nine months of operations for the period ended September 30, 2011. There were no comparable results of operations for the nine months ended September 30, 2010.

In August 2011, the Company formed Dubose Advisors, LLC (“**Dubose Advisors**”) a wholly-owned Delaware limited liability company, and sponsored the formation of Dubose Model Home Investors #201, LP. (“**201 Partnership**”), a California limited partnership. Dubose Advisors is the general partner and advisor to the 201 partnership. The 201 Partnership will also invest in Model Homes it purchases from developers in transactions whereby the developer leases back the Model Home under a short term lease, typically one to three years in length similar to NetREIT Dubose. The Company has initially invested \$250,000 to capitalize the 201 Partnership and has commenced raising \$1,750,000 in outside investor capital through the sale of 35 limited partner units at \$50,000 per unit. The 201 Partnership has been consolidated with the financial statements of the Company.

**Basis of Presentation.** The accompanying condensed consolidated financial statements have been prepared by the Company’s management in accordance with accounting principles generally accepted in the United States of America (“**GAAP**”). Certain information and footnote disclosures required for annual consolidated financial statements have been condensed or excluded pursuant to rules and regulations of the U.S. Securities and Exchange Commission (“**SEC**”). In the opinion of management, the accompanying condensed consolidated financial statements reflect all adjustments of a normal and recurring nature that are considered necessary for a fair presentation of our financial position, results of our operations, and cash flows as of and for the three and nine months ended September 30, 2011 and 2010. However, the results of operations for the interim periods are not necessarily indicative of the results that may be expected for the year ending December 31, 2011. These condensed consolidated financial statements should be read in conjunction with the audited financial statements and notes thereto included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2010. The condensed consolidated balance sheet at December 31, 2010 has been derived from the audited consolidated financial statements included in the Form 10-K.

## 2. SIGNIFICANT ACCOUNTING POLICIES

**Principles of Consolidation.** The accompanying condensed consolidated financial statements include the accounts of NetREIT and its 15 subsidiary entities, FMP, the NetREIT Partnerships, the Dubose Partnerships, NetREIT Advisors, Dubose Advisors and NetREIT Dubose. Reference to the “Company” herein includes these 15 subsidiary entities. All significant intercompany balances and transactions have been eliminated in consolidation.

Prior to formation of the NetREIT Partnerships, the properties owned by those partnerships were held as tenants in common (“TIC”) with the other investors and accounted for using the equity method due to substantive participation rights of the TIC. Upon formation of the NetREIT Partnerships, NetREIT became the sole general partner in each of these partnerships and the rights of the other partners were limited to certain protective rights. As a result of the change in the Company’s ability to influence and control the NetREIT Partnerships, they are now accounted for as subsidiaries of the Company and are fully consolidated in the Company’s financial statements.

The Company classifies the noncontrolling interests in FMP, the 4 NetREIT Partnerships, and 6 of the 7 Dubose Partnerships as part of consolidated net loss in 2011 and 2010, and includes the accumulated amount of noncontrolling interests as a component of shareholders’ equity. If a change in ownership of a consolidated subsidiary results in loss of control and deconsolidation, any retained ownership interest will be remeasured with the gain or loss reported in the statement of operations. Management has evaluated the noncontrolling interests and determined that they do not contain any redemption features.

**Federal Income Taxes.** The Company has elected to be taxed as a REIT under Sections 856 through 860 of the Code, for federal income tax purposes. To qualify as a REIT, the Company must distribute annually at least 90% of adjusted taxable income, as defined in the Code, to its shareholders and satisfy certain other organizational and operating requirements. As a REIT, no provision will be made for federal income taxes on income resulting from those sales of real estate investments which have or will be distributed to shareholders within the prescribed limits. However, taxes will be provided for those gains which are not anticipated to be distributed to shareholders unless such gains are deferred pursuant to Section 1031. In addition, the Company will be subject to a federal excise tax which equals 4% of the excess, if any, of 85% of the Company’s ordinary income plus 95% of the Company’s capital gain net income over cash distributions, as defined.

Earnings and profits that determine the taxability of distributions to shareholders differ from net income reported for financial reporting purposes due to differences in estimated useful lives and methods used to compute depreciation and the carrying value (basis) on the investments in properties for tax purposes, among other things. During the nine months ended September 30, 2011 and the year ended December 31, 2010, all distributions were considered return of capital to the shareholders and therefore non-taxable.

The Company believes that it has met all of the REIT distribution and technical requirements for the nine months ended September 30, 2011 and the year ended December 31, 2010.

The Company has concluded that there are no significant uncertain tax positions requiring recognition in its financial statements. Neither the Company nor its subsidiaries have been assessed interest or penalties by any major tax jurisdictions. The Company could be subject to routine audits by taxing jurisdictions; however, there currently are no audits for any tax periods in progress.

**Real Estate Asset Acquisitions.** The Company accounts for its acquisitions of real estate in accordance with GAAP which require the purchase price of acquired properties to be allocated to the acquired tangible assets and liabilities, consisting of land, building, tenant improvements, a land purchase option, long-term debt and identified intangible assets and liabilities, consisting of the value of above-market and below-market leases, the value of in-place leases, unamortized lease origination costs and tenant relationships, based in each case on their fair values.

The Company allocates the purchase price to tangible assets of an acquired property (which includes land, building and tenant improvements) based on the estimated fair values of those tangible assets, assuming the building was vacant. Estimates of fair value for land, building and building improvements are based on many factors including, but not limited to, comparisons to other properties sold in the same geographic area and independent third party valuations. The Company also considers information obtained about each property as a result of its pre-acquisition due diligence, marketing and leasing activities in estimating the fair values of the tangible and intangible assets and liabilities acquired.

The total value allocable to intangible assets acquired, which consists of unamortized lease origination costs, in-place leases and tenant relationships, are allocated based on management's evaluation of the specific characteristics of each tenant's lease and the Company's overall relationship with that respective tenant. Characteristics considered by management in allocating these values include the nature and extent of the existing business relationships with the tenant, growth prospects for developing new business with the tenant, the remaining term of the lease and the tenant's credit quality, among other factors.

The value allocable to above or below market component of an acquired in-place lease is determined based upon the present value (using a market discount rate) of the difference between (i) the contractual rents to be paid pursuant to the lease over its remaining term, and (ii) management's estimate of rents that would be paid using fair market rates over the remaining term of the lease. The amounts allocated to above or below market leases are included in lease intangibles, net in the accompanying balance sheets and are amortized on a straight-line basis as an increase or reduction of rental income over the remaining non-cancelable term of the respective leases. Amortization of above market rents was \$106,094 and \$195,401 for the three and nine months ended September 30, 2011, respectively. There was no amortization of above market rents in the three and nine months ended September 30, 2010.

The value of in-place leases, unamortized lease origination costs and tenant relationships are amortized to expense over the remaining term of the respective leases, which range from less than a year to ten years. The value of above market rents are amortized against rental income over the terms of the respective leases. The amount allocated to acquire in-place leases is determined based on management's assessment of lost revenue and costs incurred for the period required to lease the "assumed vacant" property to the occupancy level when purchased. The amount allocated to unamortized lease origination costs is determined by what the Company would have paid to a third party to secure a new tenant reduced by the expired term of the respective lease. The amount allocated to tenant relationships is the benefit resulting from the likelihood of a tenant renewing its lease. Amortization expense related to these assets was \$109,094 and \$90,126 for the three months ended September 30, 2011 and 2010, respectively. Amortization related to these assets was \$292,658 and \$307,199 for the nine months ended September 30, 2011 and 2010, respectively.

**Sales of Real Estate Assets.** Gains from the sale of real estate assets will not be recognized under the full accrual method by the Company until certain criteria are met. Gain or loss (the difference between the sales value and the cost of the real estate sold) shall be recognized at the date of sale if a sale has been consummated and the following criteria are met:

- a. The buyer is independent of the seller;
- b. Collection of the sales price is reasonably assured; and
- c. The seller will not be required to support the operations of the property or its related obligations to an extent greater than its proportionate interest.

Gains relating to transactions which do not meet the criteria for full accrual method of accounting are deferred and recognized when the full accrual method of accounting criteria are met or by using the installment or deposit methods of profit recognition, as appropriate in the circumstances.

As of September 30, 2011, management has concluded that there are 13 model home properties aggregating approximately \$5.0 million which are considered as held for sale and are included in real estate assets. These homes have mortgage notes payable of approximately \$2.6 million.

**Depreciation and Amortization of Buildings and Improvements.** Land, buildings and improvements are recorded at cost. Major replacements and betterments, which improve or extend the life of the asset, are capitalized and depreciated over their estimated useful lives, while ordinary repairs and maintenance are expensed as incurred. The cost of buildings and improvements are depreciated using the straight-line method over estimated useful lives ranging from 30 to 55 years for buildings, improvements are amortized over the shorter of the estimated life of the asset or term of the tenant lease which range from 1 to 10 years, and 4 to 5 years for furniture, fixtures and equipment. Depreciation expense for buildings and improvements for the three months ended September 30, 2011 and 2010, was \$907,925 and \$763,459, respectively. Depreciation expense for buildings and improvements for the nine months ended September 30, 2011 and 2010, was \$2,645,112 and \$2,160,645, respectively.

**Impairment.** The Company reviews the carrying value of each property to determine if circumstances that indicate impairment in the carrying value of the investment exist or that depreciation periods should be modified. If circumstances support the possibility of impairment, the Company prepares a projection of the undiscounted future cash flows, without interest charges, of the specific property and determines if the investment in such property is recoverable. If impairment is indicated, the carrying value of the property is written down to its estimated fair value based on the Company's best estimate of the property's discounted future cash flows. For the year ended December 31, 2010 the Company determined that an impairment existed with respect to its Havana Parker Complex property and, further as a result, recorded an asset impairment of \$1 million. As of September 30, 2011, management does not believe indicators of impairment were evident and, as such, no impairment charges were recognized.

**Intangible Assets.** Lease intangibles represents the allocation of a portion of the purchase price of a property acquisition representing the estimated value of in-place leases, unamortized lease origination costs, tenant relationships and a land purchase option. Intangible assets are comprised of finite-lived and indefinite-lived assets. Indefinite-lived assets are not amortized. Finite-lived intangibles are amortized over their expected useful lives.

The Company is required to perform a test for impairment of goodwill and other definite and indefinite lived assets at least annually, and more frequently as circumstances warrant. Based on the review, no impairment was deemed necessary at December 31, 2010 and, as of September 30, 2011, management does not believe that any indicators of impairment were evident.

Other intangible assets that are not deemed to have an indefinite useful life are amortized over their estimated useful lives. The carrying amount of intangible assets that are not deemed to have an indefinite useful life is regularly reviewed for indicators of impairments in value. Impairment is recognized only if the carrying amount of the intangible asset is considered to be unrecoverable from its undiscounted cash flows and is measured as the difference between the carrying amount and the estimated fair value of the asset. Based on the review, no impairment was deemed necessary at December 31, 2010 and, as of September 30, 2011, management does not believe that any indicators of impairment were evident.

**Other Real Estate Owned.** The Company acquired a property in Escondido, CA through foreclosure proceedings in May 2009. At the time we acquired title to the property we entered into an exclusive option with the borrower to sell the property back at our investment plus additional expenditures and interest charges through the date the original borrower purchased back the property. The option expired in late 2010. The Company has not actively engaged in the attempted sale of the property while management studies the best use options for the property.

**Revenue Recognition.** The Company recognizes revenue from rent, tenant reimbursements, and other revenue once all of the following criteria are met:

- a. persuasive evidence of an arrangement exists;
- b. delivery has occurred or services have been rendered;
- c. the amount is fixed or determinable; and
- d. the collectability of the amount is reasonably assured.

Annual rental revenue is recognized in rental revenues on a straight-line basis over the term of the related lease. Estimated recoveries from certain tenants for their pro rata share of real estate taxes, insurance and other operating expenses are recognized as revenues in the period the applicable expenses are incurred or as specified in the leases.

Certain of the Company's leases currently contain rental increases at specified intervals. The Company records as an asset, and includes in revenues, deferred rent receivable that will be received if the tenant makes all rent payments required through the expiration of the initial term of the lease. Deferred rent receivable in the accompanying balance sheets includes the cumulative difference between rental revenue recorded on a straight-line basis and rents received from the tenants in accordance with the lease terms. Accordingly, the Company determines, in its judgment, to what extent the deferred rent receivable applicable to each specific tenant is collectible. The Company reviews material deferred rent receivable, as it relates to straight-line rents, on a quarterly basis and takes into consideration the tenant's payment history, the financial condition of the tenant, business conditions in the industry in which the tenant operates and economic conditions in the area in which the property is located. In the event that the collectability of deferred rent with respect to any given tenant is in doubt, the Company records an increase in the allowance for uncollectible accounts or records a direct write-off of the specific rent receivable. No such reserves have been recorded as of September 30, 2011 and December 31, 2010.

**Loss Per Common Share.** Basic loss per common share ("**Basic EPS**") is computed by dividing net loss available to common shareholders (the "numerator") by the weighted average number of common shares outstanding (the "denominator") during the period. Diluted loss per common share ("**Diluted EPS**") is similar to the computation of Basic EPS except that the denominator is increased to include the number of additional common shares that would have been outstanding if the dilutive potential common shares had been issued. In addition, in computing the dilutive effect of convertible securities, the numerator is adjusted to add back the after-tax amount of interest recognized in the period associated with any convertible debt. The computation of Diluted EPS does not assume exercise or conversion of securities that would have an anti-dilutive effect on net earnings per share.

The following is a reconciliation of the denominator of the basic loss per common share computation to the denominator of the diluted loss per common share computations, for the three and nine months ended September 30:

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2011	2010	2011	2010
Weighted average shares used for Basic EPS	13,409,931	11,509,003	13,027,349	10,964,396
Effect of dilutive securities:				
Incremental shares from share-based compensation	—	—	—	—
Incremental shares from conversion of :				
NetREIT 01 LP Partnership	—	—	—	—
NetREIT Casa Grande LP Partnership				
NetREIT Palm LP Partnership	—	—	—	—
Garden Gateway LP Partnership				
Incremental shares from warrants	—	—	—	—
Adjusted weighted average shares used for diluted EPS	13,409,931	11,509,003	13,027,349	10,964,396

Weighted average shares from unvested restricted stock grants, shares from conversion of NetREIT 01 LP Partnership, Casa Grande LP Partnership, NetREIT Palm Self-Storage LP Partnership, NetREIT Garden Gateway LP Partnership and shares from stock purchase warrants with respect to a total of 974,292 and 966,074 shares of common stock for the three and nine months ended September 30, 2011 and 2010, respectively, were excluded from the computation of diluted earnings per share as their effect was anti-dilutive.

**Fair Value of Financial Instruments and Certain Other Assets/Liabilities.** The Company calculates the fair value of financial instruments using available market information and appropriate present value or other valuation techniques such as discounted cash flow analyses. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. The derived fair value estimates cannot always be substantiated by comparison to independent markets and in many cases, could not be realized in immediate settlement of the instruments. Management believes that the carrying values reflected in the accompanying balance sheets reasonably approximate the fair values for financial instruments.

The Company does not have any assets or liabilities that are measured at fair value on a recurring basis and, as of September 30, 2011 and December 31, 2010, does not have any assets or liabilities that were measured at fair value on a nonrecurring basis.

In the opinion of management, the fair value of related party transactions cannot be estimated without incurring excessive costs; for that reason, the Company has not provided such disclosure. Other information about related party transactions are provided, where applicable, elsewhere in these notes to the condensed consolidated financial statements.

**Use of Estimates.** The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities as of the date of the financial statements, and the reported amounts of revenues and expenses during the reporting periods. Significant estimates include the allocation of purchase price paid for property acquisitions between land, building and intangible assets acquired including their useful lives; valuation of long-lived assets, and the allowance for doubtful accounts, which is based on an evaluation of the tenants' ability to pay and the provision for possible loan losses with respect to mortgages receivable and interest. Actual results may differ from those estimates.

**Segments.** The Company acquires and operates income producing properties including office properties, residential properties, retail properties and self storage properties and invests in real estate assets, including real estate loans and, as a result, the Company operates in five business segments. See Note 8 "Segment Information".

**Recently Issued Accounting Standards Updates.** In May 2011, the FASB issued ASU No. 2011-04, *Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs* ("ASU No. 2011-04"). ASU No. 2011-04 updates and further clarifies requirements in U.S. GAAP for measuring fair value and for disclosing information about fair value measurements. Additionally, ASU No. 2011-04 clarifies the FASB's intent about the application of existing fair value measurements. ASU No. 2011-04 is effective for interim and annual periods beginning after December 15, 2011 and is applied prospectively. The Company does not expect the adoption of ASU No. 2011-04 will have a material impact to its consolidated financial statements.

In July 2010, the FASB issued ASU No. 2010-20, *Receivables (Topic 310): Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses* (“ASU No. 2010-20”). ASU No. 2010-20 requires the Company to provide a greater level of disaggregated information about the credit quality of its financing receivables and its allowance for credit losses. This ASU also requires the Company to disclose additional information related to credit quality indicators, past due information, information related to loans modified in a troubled debt restructuring and significant purchases and sales of financing receivables disaggregated by portfolio segment. ASU No. 2010-20 was initially effective for interim and annual periods ending on or after December 15, 2010. In January 2011, the FASB issued ASU No. 2011-01, *Receivables (Topic 310): Deferral of the Effective Date of Disclosures about Troubled Debt Restructurings in Update No. 2010-20* (“ASU No. 2011-01”). ASU No. 2011-01 announced that it was deferring the effective date of new disclosure requirements for troubled debt restructurings prescribed by ASU No. 2010-20. The effective date for those disclosures will be concurrent with the effective date for proposed ASU No. 2010-20. The Company adopted ASU No. 2010-20 during the quarter ended September 30, 2011, in conjunction with the effective date of ASU No. 2011-02. The adoption of ASU No. 2010-20 requires additional disclosures, but does not have a material impact on the Company’s consolidated financial statements.

**Litigation.** Neither the Company nor any of the Company’s properties are presently subject to any material litigation nor, to the Company’s knowledge, is there any material threatened litigation.

**Environmental Matters.** The Company monitors its properties for the presence of hazardous or toxic substances. While there can be no assurance that a material environmental liability does not exist, the Company is not currently aware of any environmental liability with respect to the properties that would have a material effect on the Company’s financial condition, results of operations and cash flow. Further, the Company is not aware of any environmental liability or any unasserted claim or assessment with respect to an environmental liability that the Company believes would require additional disclosure or recording of a loss contingency.

**Subsequent Events.** Management has evaluated subsequent events through the date that the accompanying financial statements were filed with the SEC for transactions and other events which may require adjustment of and/or disclosure in such financial statements.

**Reclassifications.** Certain reclassifications have been made to prior years consolidated financial statements to conform to the current year presentation. These reclassifications had no effect on previously reported results of consolidated operations or stockholders’ equity.

### 3. REAL ESTATE ASSETS AND LEASE INTANGIBLES

A summary of the twenty properties and seventy-nine model home properties owned by the Company as of September 30, 2011 is as follows:

Property Name	Date Acquired	Location	Square Footage	Property Description	Real estate assets, net (in thousands)
Casa Grande Apartments	April 1999	Cheyenne, Wyoming	29,250	Residential	\$ 1,446.4
Havana/Parker Complex	June 2006	Aurora, Colorado	114,000	Office	5,371.0
7-Eleven	September 2006	Escondido, California	3,000	Retail	1,287.8
Garden Gateway Plaza	March 2007	Colorado Springs, Colorado	115,052	Office	13,085.2
World Plaza	September 2007	San Bernardino, California	55,098	Retail	5,613.2
Regatta Square	October 2007	Denver, Colorado	5,983	Retail	1,984.1
Sparky's Palm Self-Storage	November 2007	Highland, California	50,250	Self Storage	4,627.2
Sparky's Joshua Self-Storage	December 2007	Hesperia, California	149,750	Self Storage	7,193.1
Executive Office Park	July 2008	Colorado Springs, Colorado	65,084	Office	8,719.3
Waterman Plaza	August 2008	San Bernardino, California	21,170	Retail	6,512.4
Pacific Oaks Plaza	September 2008	Escondido, California	16,000	Office	4,557.4
Morena Office Center	January 2009	San Diego, California	26,784	Office	5,933.1
Fontana Medical Plaza	February 2009	Fontana, California	10,500	Office	2,116.7
Rangewood Medical Office Building	March 2009	Colorado Springs, Colorado	18,222	Office	2,385.7
Sparky's Thousand Palms Self-Storage	August 2009	Thousand Palms, California	113,126	Self Storage	5,868.3
Sparky's Hesperia East Self-Storage	December 2009	Hesperia, California	72,940	Self Storage	2,727.5
Sparky's Rialto Self-Storage	May 2010	Rialto, California	101,343	Self Storage	5,170.4
Genesis Plaza	August 2010	San Diego, California	57,685	Office	8,983.8
Dakota Bank Buildings	May 2011	Fargo, North Dakota	119,749	Office	8,886.0
Yucca Valley Retail Center	September 2011	Yucca Valley, California	85,996	Retail	6,515.0
<b>NetREIT, Inc properties</b>					<u>108,983.6</u>
14 model home properties	Various in 2009	CA and NV	34,320	Residential	5,647.6
48 model home properties	Various in 2010 & 2011	CA, AZ, OR, WA, TX, SC, NC, ID and FL	199,947	Residential	11,024.8
17 model home properties, held in income funds	Various 2003-2008	TX, WA, OH, NC, NV, CA, NJ and MI	37,389	Residential	4,558.2
<b>Model home properties</b>					<u>21,230.6</u>
					<u>\$ 130,214.2</u>
				Total real estate assets, net	<u>\$ 130,214.2</u>

A summary of the eighteen properties and seventy four model home properties owned by the Company as of December 31, 2010 is as follows:

Property Name	Date Acquired	Location	Square Footage	Property Description	Real estate assets, net (in thousands)
Casa Grande Apartments	April 1999	Cheyenne, Wyoming	29,250	Residential	\$ 1,500.0
Havana/Parker Complex	June 2006	Aurora, Colorado	114,000	Office	5,469.8
7-Eleven	September 2006	Escondido, California	3,000	Retail	1,304.0
Garden Gateway Plaza	March 2007	Colorado Springs, Colorado	115,052	Office	13,088.5
World Plaza	September 2007	San Bernardino, California	55,098	Retail	5,716.8
Regatta Square	October 2007	Denver, Colorado	5,983	Retail	1,989.2
Sparky's Palm Self-Storage	November 2007	Highland, California	50,250	Self Storage	4,712.2
Sparky's Joshua Self-Storage	December 2007	Hesperia, California	149,750	Self Storage	7,322.7
Executive Office Park	July 2008	Colorado Springs, Colorado	65,084	Office	8,849.0
Waterman Plaza	August 2008	San Bernardino, California	21,170	Retail	6,592.5
Pacific Oaks Plaza	September 2008	Escondido, California	16,000	Office	4,623.5
Morena Office Center	January 2009	San Diego, California	26,784	Office	6,069.7
Fontana Medical Plaza	February 2009	Fontana, California	10,500	Office	2,170.6
Rangewood Medical Office Building	March 2009	Colorado Springs, Colorado	18,222	Office	2,451.9
Sparky's Thousand Palms Self-Storage	August 2009	Thousand Palms, California	113,126	Self Storage	5,976.1
Sparky's Hesperia East Self-Storage	December 2009	Hesperia, California	72,940	Self Storage	2,755.6
Sparky's Rialto Self-Storage	May 2010	Rialto, California	101,343	Self Storage	4,830.3
Genesis Plaza	August 2010	San Diego, California	57,685	Office	9,053.6
<b>NetREIT, Inc properties</b>					<u>94,476.0</u>
19 model home properties	Various in 2009	CA and NV	47,637	Residential	7,483.8
26 model home properties	Various in 2010	CA, AZ, OR, WA and TX	62,349	Residential	5,654.9
29 model home properties, held in income funds	Various 2003-2008	TX, AZ, WA, OH, NC, NV, NJ and MI	69,907	Residential	9,510.7
<b>Model home properties</b>					<u>22,649.4</u>
					<u>\$ 117,125.4</u>

The following table sets forth the components of the Company's real estate assets:

	<i>September 30, 2011</i>	<i>December 31, 2010</i>
Land	\$ 26,179,319	\$ 22,413,950
Buildings and other	109,281,490	98,639,739
Tenant improvements	<u>5,285,963</u>	<u>4,147,535</u>
	140,746,772	125,201,224
Less:		
Accumulated depreciation and amortization	<u>(10,532,570)</u>	<u>(8,075,805)</u>
Real estate assets, net	<u>\$ 130,214,202</u>	<u>\$ 117,125,419</u>

Operations from each property are included in the Company's condensed consolidated financial statements from the date of acquisition.

The Company acquired the following properties in 2011:

In January 2011, NetREIT Dubose acquired two model home properties in Texas and leased them back to the home builder. The purchase price for the properties was \$0.45 million. NetREIT Dubose paid the purchase price through a cash payment of \$0.23 million and two promissory notes totaling \$0.22 million.

In February 2011, NetREIT Dubose acquired five model home properties in California and leased them back to the home builder. The purchase price for the properties was \$1.5 million. NetREIT Dubose paid the purchase price through a cash payment of \$0.75 million and five promissory notes totaling \$0.75 million.

In March 2011, NetREIT Dubose acquired four model home properties in South Carolina, Florida and Texas and leased them back to the home builder. The purchase price for the properties was \$1.0 million. NetREIT Dubose paid the purchase price through a cash payment of \$0.50 million and four promissory notes totaling \$0.50 million.

In May 2011, the Company acquired vacant land consisting of approximately 3 acres adjacent to its Sparky's Rialto Self-Storage facility for approximately \$0.4 million paid in cash. The Company intends to use the land for additional motor home parking or for other purposes.

In May 2011, the Company acquired the Dakota Bank Buildings for the purchase price of approximately \$9.6 million. The Property is a six-story, two building office complex built in 1981 and 1986 located on 1.58 acres and consists of approximately 120,000 rentable square feet in downtown Fargo, North Dakota. The Company made a down payment of approximately \$3.875 million and financed the remainder of the purchase price through a monthly adjustable rate mortgage with interest at 3.0% over the one month Libor with an interest rate floor of 5.75% and ceiling of 9.75%.

In June 2011, NetREIT Dubose acquired three model home properties in Texas and leased them back to the home builder. The purchase price for the properties was approximately \$0.60 million. NetREIT Dubose paid the purchase price through a cash payment of approximately \$0.30 million and three promissory notes totaling approximately \$0.30 million.

In August 2011, NetREIT Dubose acquired eight model home properties in Texas, Florida, North Carolina and South Carolina and leased them back to the home builder. The purchase price for the properties was approximately \$1.9 million. NetREIT Dubose paid the purchase price through a cash payment of approximately \$1.0 million and eight promissory notes totaling approximately \$0.90 million.

In September 2011, the Company acquired the Yucca Valley Retail Center for the purchase price of approximately \$6.8 million. The Property is a neighborhood shopping center complex built in approximately 1978 consisting of five separate parcels. The Property consists of approximately 86,000 rentable square feet and is currently 93% leased and anchored by a national chain grocery store. The Company paid the purchase price through a cash payment of approximately \$3.5 million and assumed a loan secured by the property of approximately \$3.3 million with an interest rate of 5.62%.

The Company disposed of the following properties in 2011:

During the nine months ended September 30, 2011, NetREIT Dubose disposed of eighteen model home properties. The sales price aggregated approximately \$6.6 million and approximately \$4.4 million in mortgage notes payable were retired in connection with these sales.



The Company acquired the following properties in 2010:

In May 2010, the Company completed the acquisition of Sparky's Rialto Self Storage (Formerly known as Las Colinas Self Storage) located in Rialto, California. The purchase price was \$4.9 million. The Company paid the purchase price through a cash payment of approximately \$2.0 million and a promissory note in the amount of approximately \$2.9 million. The property consists of approximately 7.5 acres of land, 101,343 rentable square feet and approximately 771 self storage units.

In August, 2010, the Company completed the acquisition of Genesis Plaza. The purchase price was \$10.0 million. The Company paid the purchase price through a cash payment of \$5.0 million and a new mortgage loan with an insurance company secured by the Property of \$5.0 million. The loan bears interest at 4.65% with a 25 year amortization schedule and a maturity date of August, 24, 2015 that may be extended for an additional 5 years at the lender's discretion subject to a change in the interest rates and other terms of the agreement. The Property is a four-story suburban office building built in 1988 and located in the Kearny Mesa submarket of San Diego, California, consisting of 57,685 rentable square feet.

In October 2010, NetREIT Dubose acquired four model home properties in Arizona and leased them back to the home builder. The purchase price for the properties was \$0.9 million. NetREIT Dubose paid the purchase price through a cash payment of \$0.45 million and four promissory notes totaling \$0.45 million.

In October 2010, NetREIT Dubose acquired ten model home properties in Oregon, Idaho and Washington and leased them back to the home builder. The purchase price for the properties was \$6.1 million. NetREIT Dubose paid the purchase price through a cash payment of \$3.05 million and ten promissory notes totaling \$3.05 million.

In November 2010, the Company completed its tender offer for the purchase of outstanding partnership units of the three Income Funds. The tender resulted in the Company acquiring 73.6%, 70.5% and 66.6% of the outstanding units of DMHI Fund #3, DMHI Fund #4 and DMHI Fund #5, respectively through the issuance of 112,890 shares of common stock and \$896,893 in cash. As of the date of acquisition, these funds owned a total of 29 model home properties.

In December 2010, NetREIT Dubose acquired twelve model home properties in Texas and leased them back to the home builder. The purchase price for the properties was \$2.9 million. NetREIT Dubose paid the purchase price through a cash payment of \$1.45 million and twelve promissory notes totaling \$1.45 million.

The Company allocated the purchase price of the properties acquired during the nine months ended September 30, 2011 as follows:

	<u>Land</u>	<u>Buildings and other</u>	<u>Tenant Improvements</u>	<u>In-place Leases</u>	<u>Above Market Leases</u>	<u>Below Market Leases</u>	<u>Total Purchase Price</u>
Model Home Properties	\$ 925,120	\$ 4,721,260	\$ -	\$ -	\$ -	\$ -	\$ 5,646,380
Sparky's Rialto Self-Storage	415,000	-	-	-	-	-	415,000
Dakota Bank Building	832,000	8,123,461	131,982	45,186	442,371	-	9,575,000
Yucca Valley Retail Center	2,445,331	3,549,162	520,485	819,979	274,168	(841,425)	6,767,700

The Company allocation of properties sold during the nine months ended September 30, 2011 is as follows:

	<u>Land</u>	<u>Buildings and other</u>	<u>Accumulated Depreciation</u>	<u>Net Book Value</u>
Model Home Properties	\$ 852,083	\$ 5,960,113	\$ 188,345	\$ 6,623,851

The Company allocated the purchase price of the properties acquired during the twelve months ended December 31, 2010 as follows:

	<u>Land</u>	<u>Buildings and other</u>	<u>Tenant Improvements</u>	<u>In-place Leases</u>	<u>Leasing Costs</u>	<u>Above Market Leases</u>	<u>Total Purchase Price</u>
Sparky's Rialto Self-Storage	\$ 1,055,000	\$ 3,820,000	\$ -	\$ -	\$ -	\$ -	\$ 4,875,000
Genesis Plaza	1,400,000	7,543,510	200,954	219,070	247,774	388,692	10,000,000
Model Home Properties	1,043,097	4,630,953	-	-	-	-	5,674,050

## Lease Intangibles

The following table summarizes the net value of other intangible assets and the accumulated amortization for each class of intangible asset:

	September 30, 2011			December 31, 2010		
	Lease intangibles	Accumulate d amortization	Lease intangibles, net	Lease intangibles	Accumulate d amortization	Lease intangibles, net
In-place leases	\$ 1,875,589	\$ (728,116)	\$ 1,147,473	\$ 1,031,792	\$ (558,854)	\$ 472,938
Leasing costs	1,047,837	(547,135)	500,702	894,487	(423,738)	470,749
Tenant relationships	332,721	(332,721)	-	332,721	(332,721)	-
Below-market leases	(841,425)	-	(841,425)	-	-	-
Above-market leases	1,105,231	(238,173)	867,058	388,692	(42,772)	345,920
	<u>\$ 3,519,953</u>	<u>\$ (1,846,145)</u>	<u>\$ 1,673,808</u>	<u>\$ 2,647,692</u>	<u>\$ (1,358,085)</u>	<u>\$ 1,289,607</u>

As of September 30, 2011, the estimated aggregate amortization expense for the three months ended December 31, 2011 and each of the five succeeding fiscal years and thereafter is as follows:

	Estimated Aggregate Amortization Expense
Three month period ending December 31, 2011	\$ 283,085
2012	931,899
2013	431,619
2014	336,659
2015	240,582
Thereafter	(550,036)
	<u>\$ 1,673,808</u>

The weighted average amortization period for the intangible assets, in-place leases, leasing costs, tenant relationships above and below-market leases acquired as of September 30, 2011 was 23.2 years.

#### 4. MORTGAGE NOTES PAYABLE

Mortgage notes payable as of September 30, 2011 and December 31, 2010 consisted of the following:

	<i>September 30, 2011</i>	<i>December 31, 2010</i>
Mortgage note payable in monthly installments of \$24,330 through July 1, 2016, including interest at a fixed rate of 6.51%, collateralized by the Havana/Parker Complex property.	<b>\$ 3,261,599</b>	<b>\$ 3,323,714</b>
Mortgage note payable in monthly installments of \$71,412 through April 5, 2014, including interest at a fixed rate of 6.08%; collateralized by the leases and office buildings of the Garden Gateway Plaza property. Certain obligations under the note are guaranteed by the executive officers.	9,602,474	9,823,854
Mortgage note payable in monthly installments of \$27,088 through February 1, 2012, including interest at a fixed rate of 5.31%; collateralized by the World Plaza property.	3,101,205	3,231,661
Mortgage note payable in monthly installments of \$25,995 through September 1, 2015, including interest at a fixed rate of 6.5%; collateralized by the Waterman Plaza property.	3,639,996	3,700,953
Mortgage note payable in monthly installments of \$28,842 through March 1, 2034, including interest at a variable rate ranging from 5.5% to 10.5%; with a current rate of 5.5% collateralized by the Sparky's Thousand Palms Self-Storage property.	4,457,206	4,539,478
Mortgage note payable in monthly installments of \$9,432 through December 18, 2016, including interest at a fixed rate of 5.00%; collateralized by the Sparky's Hesperia East Self-Storage property.	1,697,177	1,717,059
Mortgage note payable in monthly installments of \$17,226 through May 3, 2015, including interest at a fixed rate of 5.00%; monthly installments of \$19,323 from June 3, 2012, including interest at 6.25% to maturity, collateralized by the Sparky's Rialto Self-Storage property.	2,836,313	2,887,597
Mortgage note payable in monthly installments of \$28,219 through September 1, 2015, including interest at a fixed rate of 4.65%; collateralized by the Genesis Plaza property.	4,882,316	4,973,365
Mortgage note payable in monthly installments of \$6,638 through July 1, 2018, including interest at a fixed rate of 5.80%; collateralized by the Casa Grande Apartment property (1).	1,045,415	-
Mortgage note payable in monthly installments of \$26,962 through July 1, 2025, including interest at a fixed rate of 5.79% through July 1, 2018; collateralized by the Executive Office Park property.	4,586,183	-
Mortgage note payable in monthly installments sufficient to amortize the note on a 25 year schedule and the current month interest charge (currently, approximately \$36,200), interest at a variable rate of 3.0% over the one month libor with a floor of 5.75% and a ceiling of 9.75% through May 31, 2016; collateralized by the Dakota Bank Building property.	5,666,052	-
Mortgage note payable in monthly installments of \$23,919 through May 11, 2015, including interest at a fixed rate of 5.62%; collateralized by the Yucca Valley Retail Center.	3,328,700	-
Subtotal, NetREIT, Inc. properties	<u>48,104,636</u>	<u>34,197,681</u>
Mortgage notes payable in monthly installments of \$25,416 through February 10, 2012, including interest at a fixed rate of 5.50%; collateralized by 11 model home properties.	2,233,666	2,937,316
Mortgage notes payable in monthly installments of \$10,001 through September 18, 2012, including interest at a fixed rate of 6.50%; collateralized by 2 model home properties.	880,676	1,873,193
Mortgage notes payable in monthly installments of \$3,767 through September 15, 2012, including interest at a fixed rate of 5.75%; collateralized by 4 model home properties.	433,232	447,822

Mortgage notes payable in monthly installments of \$19,792 through December 15, 2015, including interest at a fixed rate of 5.75%; collateralized by 22 model home properties.	2,231,148	2,374,881
Mortgage notes payable in monthly installments of \$4,308 maturity date of October 5, 2011, including interest at a fixed rate of 2.38%; collateralized by 1 model home property.(2)	580,282	2,583,323
Mortgage notes payable in monthly installments of \$6,984 maturities varying from October 5, 2011 to March 5, 2012, including interest at fixed rates from 2.38%, to 2.55%; collateralized by 3 model home properties.(2)	759,163	1,994,260
Mortgage notes payable in monthly installments of \$3,857 maturities varying from October 5, 2011 to December 5, 2011, including interest at fixed rates from 6.36%, to 7.16%; collateralized by 2 model home properties.(2)	567,855	2,836,311
Mortgage notes payable in monthly installments of \$23,686 maturities varying from February 15, 2016 to August 15, 2016, including interest at fixed rates from 5.75%, to 6.30%; collateralized by 23 model home properties.	2,777,506	-
Subtotal, model home properties	<u>10,463,528</u>	<u>15,047,106</u>
	<u>\$ 58,568,164</u>	<u>\$ 49,244,787</u>

(1) The Company established a separate purpose entity to be the legal borrower under this real estate note and mortgage and security agreement. NetREIT has guaranteed this note with full recourse liability under the loan.

(2) The Company is working with the lender to extend the maturity dates of these loans.

As of September 30, 2011, The Company is in compliance with all conditions and covenants of its mortgage notes payable.

Scheduled principal payments of mortgage notes payable as of September 30, 2011 are as follows:

Years Ending:	NetREIT, Inc. Principal Payments	Model Home Properties Principal Payments	Scheduled Principal Payments
Three month period ending December 31, 2011	\$ 204,591	\$ 2,153,716	\$ 2,358,307
2012	4,105,285	3,324,604	7,429,889
2013	1,090,311	269,649	1,359,960
2014	9,807,428	285,352	10,092,780
2015	13,983,836	2,306,630	16,290,466
Thereafter	18,913,185	2,123,577	21,036,762
Total	<u>\$ 48,104,636</u>	<u>\$ 10,463,528</u>	<u>\$ 58,568,164</u>

## 5. RELATED PARTY TRANSACTIONS

The Company leases a portion of its corporate headquarters at Pacific Oaks Plaza in Escondido, California to C.I. Holding Group, Inc. and Subsidiaries (“CI”), a small shareholder in the Company that is approximately 35% owned by the Company’s executive management. Total rents charged and paid by these affiliates was approximately \$14,281 and \$12,487 for the three months ended September 30, 2011 and 2010, respectively. Total rents charged and paid by these affiliates was approximately \$42,842 and \$37,460 for the nine months ended September 30, 2011 and 2010, respectively.

The Company has entered into a property management agreement with CHG Properties, Inc. (“CHG”), a wholly-owned subsidiary of CI, to manage all of its properties at rates up to 5% of gross income. During the three months ended September 30, 2011 and 2010, the Company paid CHG total management fees of \$167,774 and \$103,000, respectively. During the nine months ended September 30, 2011 and 2010, the Company paid CHG total management fees of \$375,482 and \$295,770, respectively.

During the term of the property management agreement, the Company has an option to acquire the business conducted by CHG. The option is exercisable, with the approval of a majority of the Company’s directors not otherwise interested in the transaction, without any consent of the property manager, its board or its shareholders. The option price is shares of the Company to be determined by a predefined formula based on the net income of CHG during the 6-month period immediately preceding the month in which the acquisition notice is delivered.

In February 2010, the Company completed the DMHU acquisition as described in Note 1. Larry Dubose, a director of the Company since 2005, was founder, owner, chief executive officer and Chairman of DMHU and certain of its affiliates. Mr. Dubose will continue to serve as a director, officer and employee of the Company and certain of its affiliates.

In March 2011, the Company purchased 9,560 shares of its vested restricted common stock compensation from its independent Board of Directors for a total of \$82,520. The purchase price of approximately \$8.60 per share was determined using the same value for the shares as reported as income to state and Federal income tax authorities.

## 6. SHAREHOLDERS' EQUITY

### Employee Retirement and Share-Based Incentive Plans

**Share-Based Incentive Plan.** An incentive award plan has been established for the purpose of attracting and retaining officers, key employees and non-employee board members. The Compensation Committee of the Board of Directors adopted a Restricted Stock plan ("**Restricted Stock**") in December 2006 and granted nonvested shares of restricted common stock effective January 1 of each of the last five years. The nonvested shares have voting rights and are eligible for any dividends paid to common shares. The share awards vest in equal annual instalments over a three or five year period from date of issuance. The Company recognized compensation cost for these fixed awards over the service vesting period, which represents the requisite service period, using the straight-line attribution expense method.

The value of the nonvested shares was calculated based on the offering price of the shares in the most recent private placement offering of \$10 adjusted for stock dividends since granted and assumed selling costs. The value of granted nonvested restricted stock issued during the nine months ended September 30, 2011 totalled \$448,400 which is calculated using the current private placement offering of \$10 adjusted for estimated selling costs. The value of granted nonvested restricted stock issued during the nine months ended September 30, 2010 totalled \$461,100. During the three months ended September 30, 2011 and 2010, \$93,300 and \$71,100 were recorded as compensation expense. During the nine months ended September 30, 2011 and 2010, \$312,540 and \$243,405, were recorded as compensation expense. The remaining 106,160 nonvested restricted shares will vest in equal installments over the next two to four years.

A table of non-vested restricted shares granted and vested since December 31, 2009 is as follows:

Balance, December 31, 2009	45,858
Granted	53,617
Vested	(37,547)
Cancelled	(286)
Balance, December 31, 2010	61,642
Granted	52,139
Vested	(2,116)
Cancelled	(5,505)
Balance, September 30, 2011	<u>106,160</u>

**Dividends.** During the nine months ended September 30, 2011 and 2010, the Company declared dividends of \$5,637,711 and \$4,797,452, respectively, or \$0.572 per share on an annualized basis. As the Company reported net losses in both of these quarters, and on a cumulative basis, these cash dividends represent a return of capital to the stockholders rather than a distribution of earnings. The Company paid cash dividends on the Series AA Preferred Stock of \$34,447 in the nine month period ended September 30, 2010. The Series AA shares were redeemed in May 2010.

## 7. SEGMENTS

The Company's reportable segments consist of the four types of commercial real estate properties for which the Company's decision-makers internally evaluate operating performance and financial results: Residential Properties, Office Properties, Retail Properties, Self-Storage Properties; and Mortgage Loans. The Company also has certain corporate level activities including accounting, finance, legal administration and management information systems which are not considered separate operating segments.

The Company's chief operating decision maker evaluates the performance of its segments based upon net operating income. Net operating income is defined as operating revenues (rental income, tenant reimbursements and other property income) less property and related expenses (property expenses, real estate taxes, ground leases and provisions for bad debts) and excludes other non-property income and expenses, interest expense, depreciation and amortization, and general and administrative expenses. The accounting policies of the reportable segments are the same as those described in the Company's significant accounting policies (see Note 2). There is no intersegment activity.

The following tables reconcile the Company's segment activity to its results of operations and financial position as of and for the three and nine months ended September 30, 2011 and 2010.

	<b>Three months ended</b>		<b>Nine months ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2011</b>	<b>2010</b>	<b>2011</b>	<b>2010</b>
<b>Office Properties:</b>				
Rental income	\$ 1,805,195	\$ 1,349,163	\$ 4,904,303	\$ 3,618,135
Property and related expenses	<u>729,139</u>	<u>603,810</u>	<u>1,983,374</u>	<u>1,723,149</u>
Net operating income, as defined	1,076,056	745,353	2,920,929	1,894,986
Equity in earnings from real estate ventures	-	-	-	(22,378)
<b>Residential Properties:</b>				
Rental income	743,916	329,051	2,312,771	820,716
Property and related expenses	<u>98,169</u>	<u>43,008</u>	<u>241,095</u>	<u>128,607</u>
Net operating income, as defined	645,747	286,043	2,071,676	692,109
Equity in earnings from real estate ventures	-	-	-	24,147
<b>Retail Properties:</b>				
Rental income	476,382	420,823	1,315,648	1,247,565
Property and related expenses	<u>143,120</u>	<u>149,836</u>	<u>387,736</u>	<u>397,783</u>
Net operating income, as defined	333,262	270,987	927,912	849,782
<b>Self Storage Properties:</b>				
Rental income	577,299	519,575	1,694,523	1,405,431
Property and related expenses	<u>339,767</u>	<u>336,254</u>	<u>1,046,968</u>	<u>943,010</u>
Net operating income, as defined	237,532	183,321	647,555	462,421
<b>Mortgage loan activity:</b>				
Interest income	<u>45,925</u>	<u>14,900</u>	<u>78,895</u>	<u>44,214</u>
<b>Reconciliation to Net Income Available to Common Shareholders:</b>				
Total net operating income, as defined, for reportable segments	2,338,522	1,500,604	6,646,967	3,945,281
Unallocated other income:				
Total other income	8,680	9,280	23,301	34,723
Loss on sale of real estate assets	(32,424)	-	(56,911)	-
General and administrative expenses	791,655	781,729	2,656,195	2,349,517
Interest expense	810,508	538,063	2,306,595	1,414,127
Depreciation and amortization	<u>1,055,025</u>	<u>880,024</u>	<u>3,036,063</u>	<u>2,547,187</u>
Net loss before noncontrolling interests	(342,410)	(689,932)	(1,385,496)	(2,330,827)
Noncontrolling interests	<u>75,187</u>	<u>60,896</u>	<u>301,305</u>	<u>155,391</u>
Net loss	(417,597)	(750,828)	(1,686,801)	(2,486,218)
Preferred stock dividends	-	-	-	(34,447)
Net loss attributable to common shareholders	<u>\$ (417,597)</u>	<u>\$ (750,828)</u>	<u>\$ (1,686,801)</u>	<u>\$ (2,520,665)</u>



	<b>September 30, 2011</b>	<b>December 31, 2010</b>
<b>Assets:</b>		
<b>Office Properties:</b>		
Land, buildings and improvements, net (1)	\$ 61,244,770	\$ 52,809,840
Total assets (2)	63,040,599	53,999,471
<b>Residential Property:</b>		
Land, buildings and improvements, net (1)	22,676,977	24,149,325
Total assets (2)	23,660,843	25,922,496
<b>Retail Properties:</b>		
Land, buildings and improvements, net (1)	23,749,875	17,228,980
Total assets (2)	24,763,606	17,467,113
<b>Self Storage Properties:</b>		
Land, buildings and improvements, net (1)	25,586,388	25,596,881
Total assets (2)	25,656,541	25,876,852
<b>Mortgage loan activity:</b>		
Mortgage receivable and accrued interest	1,032,818	920,216
Total assets	1,032,818	920,216
<b>Reconciliation to Total Assets:</b>		
Total assets for reportable segments	138,154,407	124,186,148
Other unallocated assets:		
Cash and cash equivalents	5,233,985	7,028,090
Other assets, net	3,512,389	2,101,724
Total Assets	<u>\$ 146,900,781</u>	<u>\$ 133,315,962</u>

(1) Includes lease intangibles and the land purchase option related to property acquisitions.

(2) Includes land, buildings and improvements, current receivables, deferred rent receivables and deferred leasing costs and other related intangible assets, all shown on a net basis.

	<b>Nine Months Ended September 30,</b>	
	<b>2011</b>	<b>2010</b>
<b>Capital Expenditures:(1)</b>		
<b>Office Properties:</b>		
Acquisition of operating properties	\$ 9,575,000	\$ 10,000,000
Capital expenditures and tenant improvements	766,751	648,895
<b>Residential Property:</b>		
Acquisition of operating properties	5,646,380	-
<b>Retail Properties:</b>		
Acquisition of operating properties	6,767,700	
Capital expenditures and tenant improvements	56,886	89,559
<b>Self-Storage Properties:</b>		
Acquisition of raw land	415,000	4,875,000
Capital expenditures and tenant improvements	2,300	39,713
Acquisition of operating properties, net	22,404,080	14,875,000
Capital expenditures and tenant improvements	825,937	778,167
Total real estate investments	<u>\$ 23,230,017</u>	<u>\$ 15,653,167</u>

(1) Total consolidated capital expenditures are equal to the same amounts disclosed for total reportable segments.

## 8. SUBSEQUENT EVENTS

**Stock Dividend.** In November 2011, the Company announced a 5% dividend payable in Company common stock to shareholders of record on December 2, 2011. Beginning with the financial statements issued after December 31, 2011, all loss per share calculations will be based on shares adjusted for the stock dividend as if the shares were issued at the beginning of the first period presented.

## **ITEM 2. MANAGEMENT’S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

The following discussion relates to our consolidated financial statements and should be read in conjunction with the financial statements and notes thereto appearing elsewhere in this report.

Statements contained in this “Management’s Discussion and Analysis of Financial Condition and Results of Operations” that are not historical facts may be “forward-looking statements” within the meaning of Section 27A of the Securities Act of 1934, as amended, or the Exchange Act. Such statements are subject to certain risks and uncertainties, which could cause actual results to materially differ from those projected. Some of the information presented is forward-looking in nature, including information concerning projected future occupancy rates, rental rate increases, project development timing and investment amounts. Although the information is based on our current expectations, actual results could vary from expectations stated in this report. Numerous factors will affect our actual results, some of which are beyond our control. These include the timing and strength of national and regional economic growth, the strength of commercial and residential markets, competitive market conditions, fluctuations in availability and cost of construction materials and labor resulting from the effects of worldwide demand, future interest rate levels and capital market conditions. You are cautioned not to place undue reliance on this information, which speaks only as of the date of this report. We assume no obligation to update publicly any forward-looking information, whether as a result of new information, future events or otherwise, except to the extent we are required to do so in connection with our ongoing requirements under federal securities laws to disclose material information.

You are cautioned not to place undue reliance on this information, which speaks only as of the date of this report. We assume no obligation to update publicly any forward-looking information, whether as a result of new information, future events or otherwise, except to the extent we are required to do so in connection with our ongoing requirements under federal securities laws to disclose material information. For a discussion of important risks related to our business, and an investment in our securities, including risks that could cause actual results and events to differ materially from results and events referred to in the forward-looking information Item 1A and Item 7 included in the Form 10-K as filed with the Securities and Exchange Commission.

### **OVERVIEW AND BACKGROUND**

We are incorporated under the General Corporation Law of the State of Maryland and we operate as a self-administered REIT headquartered in San Diego County, California, formed to own, operate and acquire income producing real estate properties.

## FACTORS THAT MAY INFLUENCE FUTURE RESULTS OF OPERATIONS

**Growth and Expansion.** During the last three years, we have completed the acquisition of twelve income producing properties, forty model home properties and invested in five income producing real estate partnerships with investments in model home properties. We built our operational and administrative infrastructure, including hiring a staff of quality employees, to give us the capability to become a large real estate investing company as well as having the resources to deal with the additional burden of compliance with the SEC rules and regulations. On March 1, 2010, the Company acquired the assets and six employees of DMHU. Later in the year 2010, the Company formed NetREIT Advisors and transferred the four remaining DMHU employees to this newly formed LLC. NetREIT Advisors began managing and serving as external advisor to NetREIT Dubose. NetREIT Advisors' general and administrative expenses are currently approximately \$60,000 per month. NetREIT Advisors generated fees of approximately \$132,000 and \$350,000 during the three months and nine months ended September 30, 2011, respectively. NetREIT Dubose will continue to make additional property acquisitions and we expect revenues less rental operating costs to increase at a far greater rate than our general and administrative costs. Therefore, we anticipate that our net loss will decline and will result in net income in the future.

During the last three years we experienced rapid growth, having increased capital by approximately 94.4% to \$83.6 million at September 30, 2011 from approximately \$43 million at September 30, 2008. Our investment portfolio, consisting of real estate assets, lease intangibles, investment in real estate ventures, land purchase option and mortgages receivable, have increased by 102% to approximately \$136.5 million at September 30, 2011 from \$67.5 million at September 30, 2008. The primary source of the growth in the portfolio during these three years was attributable to the issuance of common shares of approximately \$51 million and from proceeds from mortgage notes payable, net of principal repayments, of approximately \$44 million.

### Economic Outlook

The United States has shown a slow recovery from the recession that began in 2007. The current economic environment is characterized by increased residential housing foreclosures and an oversupply of homes available for purchase, depressed commercial real estate valuations, weak consumer spending, employment anxiety and concerns of inflation and higher interest rates. In general, US Corporations' net income and investment seem to be improving. However, the housing sector and finance have so far not significantly improved. We believe that the pace of this recovery will likely be slow and disjointed. Full recovery will need increasing job growth, but it will not be consistent across industries, geographies or periods of the year causing an uneven tempo of growth.

Recent U.S. debt ceiling and budget deficit concerns, together with signs of deteriorating sovereign debt conditions in Europe, have increased the possibility of additional credit-rating downgrades and economic slowdowns. Although U.S. lawmakers passed legislation to raise the federal debt ceiling, Standard & Poor's Ratings Services lowered its long-term sovereign credit rating on the United States (the "U.S.") from "AAA" to "AA+" in August 2011. The impact of this or any further downgrades to the U.S. government's sovereign credit rating, or its perceived creditworthiness, and the impact of the current crisis in Europe with respect to the ability of certain European Union countries to continue to service their sovereign debt obligations is inherently unpredictable and could adversely affect the U.S. and global financial markets and economic conditions. There can be no assurance that governmental or other measures to aid economic recovery will be effective. These developments and the government's credit concerns in general, could cause interest rates and borrowing costs to rise, which may negatively impact our ability to access the debt markets on favorable terms. Continued adverse economic conditions could have a material adverse effect on our business, financial condition and results of operations.

In addition, this difficult economic environment may also make it difficult for our tenants to continue to meet their obligations to us. We have been successful maintaining relatively even levels of occupancy at our stabilized properties; however, overall progress to date in the office leasing velocity and pricing has been inconsistent both regionally and across assets of differing quality. Vacancy rates in our markets appear to have reached the top and are starting to descend at a slow pace. Several years may be required before vacancy rates decline sufficiently to support meaningful growth in rents.

Our involvement in retail properties has been limited, however, we are seeing more rental inquiries. Retail demand for space in 2011 is expected to be positive for the first time since 2007. Although the increase is expected to be modest we, expect that well situated properties will benefit from the improving economy.

Economic growth rates have shown trends of slow growth in recent periods and inflation rates in the United States have remained low. Changes in inflation/deflation are sometimes associated with changes in long-term interest rates, which may have a negative impact on the value of the portfolio we own. To mitigate this risk, we will continue to seek to lease our properties with fixed rent increases and/or with scheduled rent increases based on formulas indexed to increases in the Consumer Price Index (“CPI”) or other indices for the jurisdiction in which the property is located. To the extent that the CPI increases, additional rental income streams may be generated from these leases and thereby mitigate the impact of inflation.

### **Management Evaluation of Results of Operations**

Management evaluates our results of operations with a primary focus on increasing and enhancing the value, quality and quantity of properties and seeking to increase value in our real estate. Management focuses its efforts on improving underperforming assets through re-leasing efforts, including negotiation of lease renewals, or selectively selling assets in order to increase value in our real estate portfolio. The ability to increase assets under management is affected by our ability to raise capital and our ability to identify appropriate investments.

Management’s evaluation of operating results includes an assessment of our ability to generate cash flow necessary to fund distributions to our shareholders. As a result, management’s assessment of operating results gives less emphasis to the effects of unrealized gains and losses and other non-cash charges such as depreciation and amortization and impairment charges, which may cause fluctuations in net income for comparable periods but have no impact on cash flows. Management’s evaluation of our potential for generating cash flow includes assessments of our recently acquired properties, our unstabilized properties, the long-term sustainability of our real estate portfolio, our future operating cash flow from anticipated acquisitions, and the proceeds from sales of our real estate.

In light of the distressed nature of the commercial real estate economy in the past several years, including 2010 and 2011, we have exercised extreme caution with respect to potential property acquisitions, and consequently, we consummated fewer property acquisitions which resulted in the accumulation of significant cash balances that affected our current cash flow due to the very low yield on cash equivalents. Net operating income from our properties, from newly acquired properties and from the model home division growth, is increasing at a faster rate than our general and administrative expenses due to efficiencies of scale. We therefore believe that when most or all of our properties are operating at stabilized rates, and when excess available cash on hand is fully invested plus future acquisitions from continuing capital raising activities, we will be able to fund our future distributions to our shareholders from cash flow from operations.

As of September 30, 2011, we owned or had a controlling interest in nine Office Properties which total approximately 543,000 rentable square feet, five Retail Properties which total approximately 171,000 rentable square feet, five Self-Storage Properties which total approximately 487,000 rentable square feet, one Residential Property and 79 model home properties.

NetREIT’s properties are located primarily in Southern California, Colorado and North Dakota with a single property located in Wyoming. Our model home properties are located in fourteen states throughout the United States. We do not develop properties but acquire properties that are stabilized or that we anticipate will be stabilized within two years of acquisition. We consider a property to be stabilized once it has achieved an 80% occupancy rate for a full year as of January 1 of such year, or has been operating for three years. Our geographical clustering of assets enables us to reduce our operating costs through economies of scale by servicing a number of properties with less staff, but it also makes us more susceptible to changing market conditions in these discrete geographic areas. Most of our office and retail properties are leased to a variety of tenants ranging from small businesses to large public companies, many of which do not have publicly rated debt. We have in the past entered into, and intend in the future to enter into, purchase agreements for real estate having net leases that require the tenant to pay all of the operating expense (Net, Net, Net Leases) or pay increases in operating expenses over specific base years.

Most of our office leases are for terms of 3 to 5 years with annual rental increases built into such leases. In general, we have been experiencing decreases in rental rates in many of our submarkets due to continuing recessionary conditions and other related factors when leases expire and are extended. We cannot give any assurance that as the older leases expire or as we add new tenants that rental rates will be equal to or above the current market rates. Also, decreased demand and other negative trends or unforeseeable events that impair our ability to timely renew or re-lease space could have a negative effect on our future financial condition, results of operations and cash flow.

The Residential Properties are rented on a short term basis of less than six months for our apartment property and typically 2 to 3 years for our model home leases. The Self-Storage Properties are rented pursuant to rental agreements that are for no longer than 6 months. The Self-Storage Properties are located in markets having other self-storage properties. Competition with these other properties will impact our operating results of these properties, which depends materially on our ability to timely lease vacant self-storage units, to actively manage unit rental rates, and our tenants' ability to make required rental payments. To be successful, we must be able to continue to respond quickly and effectively to changes in local and regional economic conditions by adjusting rental rates of these properties within their regional market in Southern California. We depend on advertisements, flyers, websites, etc. to secure new tenants to fill any vacancies.

## CRITICAL ACCOUNTING POLICIES

The presentation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses for the reporting period. Certain accounting policies are considered to be critical accounting policies, as they require management to make assumptions about matters that are highly uncertain at the time the estimate is made, and changes in the accounting estimate are reasonably likely to occur from period to period. As a company primarily involved in owning income generating real estate assets, management believes the following critical accounting policies reflect our more significant judgments and estimates used in the preparation of our financial statements. For a summary of all of our significant accounting policies, see note 2 to our financial statements included elsewhere in this report.

**Federal Income Taxes.** We have elected to be taxed as a REIT under Sections 856 through 860 of the Code, for federal income tax purposes. To qualify as a REIT, we must distribute annually at least 90% of adjusted taxable income, as defined in the Code, to our shareholders and satisfy certain other organizational and operating requirements. As a REIT, no provision will be made for federal income taxes on income resulting from those sales of real estate investments which have or will be distributed to shareholders within the prescribed limits. However, taxes will be provided for those gains which are not anticipated to be distributed to shareholders unless such gains are deferred pursuant to Section 1031. In addition, the Company will be subject to a federal excise tax which equals 4% of the excess, if any, of 85% of the Company's ordinary income plus 95% of the Company's capital gain net income over cash distributions.

Earnings and profits that determine the taxability of distributions to shareholders differ from net income reported for financial reporting purposes due to differences in estimated useful lives and methods used to compute depreciation and the carrying value (basis) on the investments in properties for tax purposes, among other things. During the year ended December 31, 2010, all distributions were considered return of capital to the shareholders and therefore non-taxable.

We believe that we have met all of the REIT distribution and technical requirements for the nine months ended September 30, 2011 and for the year ended December 31, 2010.

## REAL ESTATE ASSETS

**Property Acquisitions.** We account for our acquisitions of real estate in accordance with GAAP requiring that the purchase price of acquired properties be allocated to the acquired tangible assets and liabilities, consisting of land, building, tenant improvements, a land purchase option, long-term debt and identified intangible assets and liabilities, consisting of the value of above-market and below-market leases, the value of in-place leases, unamortized lease origination costs and tenant relationships, based in each case on their fair values.

We allocate the purchase price to tangible assets of an acquired property (which includes land, building and tenant improvements) based on the estimated fair values of those tangible assets, assuming the building was vacant. Estimates of fair value for land, building and building improvements are based on many factors including, but not limited to, comparisons to other properties sold in the same geographic area and independent third party valuations. We also consider information obtained about each property as a result of its pre-acquisition due diligence, marketing and leasing activities in estimating the fair values of the tangible and intangible assets and liabilities acquired.

The total value allocable to intangible assets acquired, which consists of unamortized lease origination costs, in-place leases and tenant relationships, are allocated based on management's evaluation of the specific characteristics of each tenant's lease and our overall relationship with that respective tenant. Characteristics considered by management in allocating these values include the nature and extent of the existing business relationships with the tenant, growth prospects for developing new business with the tenant, the remaining term of the lease and the tenant's credit quality, among other factors.

The value allocable to above or below market component of an acquired in-place lease is determined based upon the present value (using a market discount rate) of the difference between (i) the contractual rents to be paid pursuant to the lease over its remaining term, and (ii) management's estimate of rents that would be paid using fair market rates over the remaining term of the lease. The amounts allocated to above or below market leases are included in lease intangibles, net in the accompanying balance sheets and are amortized on a straight-line basis as an increase or reduction of rental income over the remaining non-cancelable term of the respective leases. Amortization of above market rents was \$106,094 and \$195,401 for the three and nine months ended September 30, 2011, respectively. There was no amortization of above market rents in the three and nine months ended September 30, 2010.

The land lease acquired with the World Plaza acquisition in 2007 has a fixed purchase price option cost of \$181,710 at the termination of the lease in 2062. Management valued the land option at its residual value of \$1,370,000, based upon comparable land sales adjusted to present value. The difference between the strike price of the option and the recorded cost of the land purchase option is approximately \$1.2 million. Accordingly, management has determined that exercise of the option is considered probable. The land purchase option was determined to be a contract based intangible asset associated with the land. As a result, this asset has an indefinite life and is treated as a non-amortizable asset. The amount is included as land purchase option in the accompanying balance sheets.

The value of in-place leases, unamortized lease origination costs and tenant relationships are amortized to expense over the remaining term of the respective leases, which range from less than a year to ten years. The value of above market rents are amortized against rental income over the terms of the respective leases. The amount allocated to acquire in-place leases is determined based on management's assessment of lost revenue and costs incurred for the period required to lease the "assumed vacant" property to the occupancy level when purchased. The amount allocated to unamortized lease origination costs is determined by what the Company would have paid to a third party to secure a new tenant reduced by the expired term of the respective lease. The amount allocated to tenant relationships is the benefit resulting from the likelihood of a tenant renewing its lease. Amortization expense related to these assets was \$109,094 and \$90,126 for the three months ended September 30, 2011 and 2010, respectively. Amortization related to these assets was \$292,658 and \$307,199 for the nine months ended September 30, 2011 and 2010, respectively.

Estimates of the fair values of the tangible and intangible assets require us to estimate market lease rates, property-operating expenses, carrying costs during lease-up periods, discount rates, market absorption periods, and the number of years the property will be held for investment. The use of inappropriate estimates would result in an incorrect assessment of our purchase price allocation, which would impact the amount of our net income.

***Sales of Undivided Interests in Properties.*** Gains from the sale of undivided interests in properties will not be recognized under the full accrual method until certain criteria are met. Gain or loss (the difference between the sales value and the proportionate cost of the partial interest sold) shall be recognized at the date of sale if a sale has been consummated and the following criteria are met:

- a. The buyer is independent of the seller;
- b. Collection of the sales price is reasonably assured; and
- c. The seller will not be required to support the operations of the property or its related obligations to an extent greater than its proportionate interest.

Gains relating to transactions which do not meet the criteria for full accrual method of accounting are deferred and recognized when the full accrual method of accounting criteria are met or by using the installment or deposit methods of profit recognition, as appropriate in the circumstances.

As of September 30, 2011, management has concluded that there are 13 model home properties aggregating approximately \$5.0 million which are considered as held for sale and are included in real estate assets. These homes have mortgage notes payable of approximately \$2.6 million.

**Depreciation and Amortization of Buildings and Improvements.** Land, buildings and improvements are recorded at cost. Major replacements and betterments, which improve or extend the life of the asset, are capitalized and depreciated over their estimated useful lives, while ordinary repairs and maintenance are expensed as incurred. The cost of buildings and improvements are depreciated using the straight-line method over estimated useful lives ranging from 30 to 55 years for buildings, improvements are amortized over the shorter of the estimated life of the asset or term of the tenant lease which range from 1 to 10 years, and 4 to 5 years for furniture, fixtures and equipment. Depreciation expense for buildings and improvements for the three months ended September 30, 2011 and 2010, was \$907,925 and \$763,459, respectively. Depreciation expense for buildings and improvements for the nine months ended September 30, 2011 and 2010, was \$2,645,112 and \$2,160,645, respectively.

**Impairment.** The Company reviews the carrying value of each property to determine if circumstances that indicate impairment in the carrying value of the investment exist or that depreciation periods should be modified. If circumstances support the possibility of impairment, the Company prepares a projection of the undiscounted future cash flows, without interest charges, of the specific property and determines if the investment in such property is recoverable. If impairment is indicated, the carrying value of the property is written down to its estimated fair value based on the Company's best estimate of the property's discounted future cash flows. For the year ended December 31, 2010 the Company determined that an impairment existed with respect to its Havana Parker Complex property and, as a result, recorded an asset impairment of \$1 million. As of September 30, 2011, management does not believe indicators of impairment were evident and as such, no impairment charges were recognized.

Our strategy is to hold properties for long-term use. If our strategy and or market conditions change or we decide to dispose of an asset, we may be required to recognize an impairment loss to reduce the property to the lower of carrying amount or fair value and such a loss could potentially be material and could adversely affect our results of operations.

**Intangible Assets.** Lease intangibles represents the allocation of a portion of the purchase price of a property acquisition representing the estimated value of in-place leases, unamortized lease origination costs, tenant relationships and a land purchase option. Intangible assets are comprised of finite-lived and indefinite-lived assets. Indefinite-lived assets are not amortized. Finite-lived intangibles are amortized over their expected useful lives. We assess our intangible assets for impairment at least annually.

We are required to perform a test for impairment of other definite and indefinite lived intangible assets at least annually, and more frequently as circumstances warrant. Our testing date is the end of our calendar year. Based on our current reviews, no impairment was deemed necessary at December 31, 2010 and, as of September 30, 2011, management does not believe that any indicators of impairment were evident.

Other intangible assets that are not deemed to have an indefinite useful life are amortized over their estimated useful lives. The carrying amount of intangible assets that are not deemed to have an indefinite useful life is regularly reviewed for indicators of impairments in value. Impairment is recognized only if the carrying amount of the intangible asset is considered to be unrecoverable from its undiscounted cash flows and is measured as the difference between the carrying amount and the estimated fair value of the asset. Based on the review, no impairment was deemed necessary at December 31, 2010 and, as of September 30, 2011, management does not believe that any indicators of impairment were evident.

**Investments in Real Estate Ventures.** We analyze our investments in joint ventures to determine whether the joint venture should be accounted for under the equity method of accounting or consolidated into the financial statements. The Company has determined that the investors held as a tenant in common in its real estate ventures have certain protective and substantive participation rights that limit our control of the investment. Therefore, our share of investment in these real estate ventures was accounted for under the equity method of accounting in the accompanying financial statements while the properties were held as a tenant in common.

Under the equity method, our investment in real estate ventures is stated at cost and adjusted for our share of net earnings or losses and reduced by distributions. Equity in earnings of real estate ventures is generally recognized based on our ownership interest in the earnings of each of the unconsolidated real estate ventures. For the purposes of presentation in the statement of cash flows, we follow the “look through” approach for classification of distributions from joint ventures. Under this approach, distributions are reported under operating cash flow unless the facts and circumstances of a specific distribution clearly indicate that it is a return of capital (e.g., a liquidating dividend or distribution of the proceeds from the joint venture’s sale of assets) in which case it is reported as an investing activity. Management assesses whether there are any indicators that the value of our investments in unconsolidated real estate ventures may be impaired when events or circumstances indicate that there may be an impairment. An investment is impaired if management’s estimate of the fair value of the investment is less than its carrying value. To the extent impairment has occurred, and is considered to be other than temporary, the loss is measured as the excess of the carrying amount of the investment over the fair value of the investment. The Company did not have any investments in real estate ventures accounted for under the equity method during the nine months ended September 30, 2011 and had three investments in real estate ventures accounted for under the equity method in the first two months of the nine months ended September 30, 2011. No impairment charges related to investments in real estate ventures were recognized over the periods the Company had these assets.

**Revenue Recognition.** We recognize revenue from rent, tenant reimbursements, and other revenue once all of the following criteria are met:

- persuasive evidence of an arrangement exists;
- delivery has occurred or services have been rendered;
- the amount is fixed or determinable; and
- the collectability of the amount is reasonably assured.

Annual rental revenue is recognized in rental revenues on a straight-line basis over the term of the related lease.

Certain of our leases currently contain rental increases at specified intervals. We record as an asset, and include in revenues, deferred rent receivable that will be received if the tenant makes all rent payments required through the expiration of the initial term of the lease. Deferred rent receivable in the accompanying balance sheets includes the cumulative difference between rental revenue recorded on a straight-line basis and rents received from the tenants in accordance with the lease terms. Accordingly, we determine, in our judgment, to what extent the deferred rent receivable applicable to each specific tenant is collectible. We review material deferred rent receivable, as it relates to straight-line rents, on a quarterly basis and take into consideration the tenant’s payment history, the financial condition of the tenant, business conditions in the industry in which the tenant operates and economic conditions in the area in which the property is located. In the event that the collectability of deferred rent with respect to any given tenant is in doubt, we record an increase in the allowance for uncollectible accounts, we record a direct write-off of the specific rent receivable. No such reserves related to deferred rent receivables have been recorded as of September 30, 2011 or December 31, 2010.

Interest income on mortgages receivable is accrued as it is earned. The Company stops accruing interest income on a loan if it is past due for more than 90 days or there is doubt regarding collectability of the loan principal and/or accrued interest receivable.

## RECENT EVENTS HAVING SIGNIFICANT EFFECT ON RESULTS OF OPERATIONS COMPARISONS

### *Property Acquisitions*

In March 2010, the Company purchased certain tangible and intangible personal property from DMHU, including rights to certain names, trademarks and trade secrets, title to certain business equipment, furnishings and related personal property. DMHU had used these assets in its previous business of purchasing model homes for investment in new residential housing tracts and initially leasing the model homes back to their developer. In addition, the Company also acquired DMHU's rights under certain contracts, including contracts to provide management services to 19 limited partnerships sponsored by DMHU and for which a DMHU affiliate serves as general partner (the "**Model Home Partnerships**"). These partnerships include DAP II and DAP III in each of which the Company was a 51% limited partner. In the DMHU Purchase, the Company paid the owners of DMHU \$300,000 cash and agreed to issue up to 120,000 shares of the Company's common stock, depending on the levels of production the Company achieves from its newly formed Model Homes Division over the next three years. The Company also agreed to continue to employ three former DMHU employees and to pay certain obligations of DMHU, including its office lease which expired on September 30, 2010. As Mr. Dubose is a Company director and was the founder and former president and principal owner of DMHU and certain of its affiliates, this transaction was completed in compliance with the Company's Board's Related Party Transaction Policy. The transaction has been accounted for as a business combination. Management performed an analysis of intangible assets acquired with the assistance of an independent valuation specialist and it was determined that \$209,000 of the purchase price is attributable to customer relationships and will be amortized over 10 years. The Company also estimated a liability of \$1,032,000 associated with the 120,000 shares that it believes will be issued in the future. As a result of the acquisition, the total purchase price of \$1,332,000 was allocated between goodwill of \$1,123,000 and intangible assets of \$209,000. As a result of the transaction, the Company's investment in DAP II and DAP III are consolidated into the financial statements of NetREIT effective March 1, 2010.

The Company has formed its Model Homes Division which will pursue investment activities based on DMHU's business model. The Model Homes Division's activities will initially include the purchase and leaseback of Model Homes in new residential housing tract developments and providing management services to the 19 Model Home Partnerships. To pursue this business, the Company formed a new subsidiary, NetREIT Advisors and is sponsoring the formation of NetREIT Dubose. NetREIT Dubose will invest in Model Homes it purchases from developers in transactions where the developer leases back the Model Home under a short term lease, typically one to three years in length. Upon expiration of the lease, NetREIT Dubose will seek to re-lease the Model Home until such time as it is able to sell the property. NetREIT Dubose will own substantially all of its assets and conduct its operations through the Operating Partnership. NetREIT Advisors serves as the advisor to NetREIT Dubose.

NetREIT Advisors will also provide management services to the 19 Model Home Partnerships, pursuant to the rights under the management contracts assigned to it by DMHU. For these services, NetREIT Advisors receives ongoing management fees and has the right to receive certain other fees when the respective partnership sells or otherwise disposes of its properties.

In May 2010, the Company completed the acquisition of Sparky's Rialto located in Rialto, California. The purchase price was \$4.9 million. The Company paid the purchase price through a cash payment of approximately \$2.0 million and a promissory note in the amount of approximately \$2.9 million. The property consists of approximately 7.5 acres of land, 101,343 rentable square feet and approximately 771 self storage units. There are three and nine months results of operations included for the three months and the nine months ended September 30, 2011. There are three and four month's results of operations included in the three and nine months ended September 30, 2010.

In July 2010, the Company capitalized NetREIT Dubose with a cash contribution of \$1.2 million in return for a convertible promissory note, which was subsequently converted to NetREIT Dubose common stock on September 30, 2010. NetREIT Dubose has also commenced raising outside investor capital pursuant to a private offering. NetREIT Dubose seeks to sell up to 2.0 million shares of its common stock at \$10.00 per share, or \$20.0 million in this private placement.

In August, 2010, the Company completed the acquisition of Genesis Plaza. The purchase price was \$10.0 million. The Company paid the purchase price through a cash payment of \$5.0 million and a new mortgage loan with an insurance company secured by the Property of \$5.0 million. The loan bears interest at 4.65% with a 25 year amortization schedule and a maturity date of August, 24, 2015 that may be extended for an additional 5 years at the lender's discretion subject to a change in the interest rates and other terms of the agreement. The Property is a four-story suburban office building built in 1988 and located in the Kearny Mesa submarket of San Diego, California, consisting of 57,685 rentable square feet. There are three and nine months results of operations included for the three months and the six months ended September 30, 2011. There are one month's results of operations included in the three and nine months ended September 30, 2010.

In October 2010, NetREIT Dubose acquired four model home properties in Arizona and leased them back to the developer. The purchase price for the properties was \$0.9 million. The Company paid the purchase price through a cash payment of \$0.45 million and four promissory notes totaling \$0.45 million. There are three and nine months results of operations included for the three months and the nine months ended September 30, 2011. There are no results of operations included in the three and nine months ended September 30, 2010.

In October 2010, NetREIT Dubose acquired ten model home properties in Oregon, Idaho and Washington and leased them back to the developer. The purchase price for the properties was \$6.1 million. The Company paid the purchase price through a cash payment of \$3.05 million and ten promissory notes totaling \$3.05 million. There are three and nine months results of operations included for the three months and the nine months ended September 30, 2011. There are no results of operations included in the three and nine months ended September 30, 2010.

In December 2010, NetREIT Dubose acquired twelve model home properties in Texas and leased them back to the developer. The purchase price for the properties was \$2.9 million. The Company paid the purchase price through a cash payment of \$1.45 million and ten promissory notes totaling \$1.45 million. There are three and nine months results of operations included for the three months and the nine months ended September 30, 2011. There are no results of operations included in the three and nine months ended September 30, 2010.

In November 2010, the Company completed its tender offer for the purchase of outstanding partnership units of the three Income Funds. The tender resulted in the Company acquiring 73.6%, 70.5% and 66.6% of the outstanding units of DMHI Fund #3, DMHI Fund #4 and DMHI Fund #5, respectively through the issuance of 112,890 shares of common stock and \$896,893 in cash. These funds own a total of 29 model home properties. There are three and nine months results of operations included for the three months and the nine months ended September 30, 2011. There are no results of operations included in the three and nine months ended September 30, 2010.

In January 2011, NetREIT Dubose acquired two model home properties in Texas and leased them back to the home builder. The purchase price for the properties was \$0.45 million. The Company paid the purchase price through a cash payment of \$0.23 million and two promissory notes totaling \$0.22 million. There are three and approximately eight months results of operations included for the three months and the nine months ended September 30, 2011. There are no results of operations included in the three and nine months ended September 30, 2010.

In February 2011, NetREIT Dubose acquired five model home properties in California and leased them back to the home builder. The purchase price for the properties was \$1.5 million. The Company paid the purchase price through a cash payment of \$0.75 million and five promissory notes totaling \$0.75 million. There are three and approximately seven months results of operations included for the three months and the nine months ended September 30, 2011. There are no results of operations included in the three and nine months ended September 30, 2010.

In March 2011, NetREIT Dubose acquired four model home properties in South Carolina, Florida and Texas and leased them back to the home builder. The purchase price for the properties was \$1.0 million. The Company paid the purchase price through a cash payment of \$0.50 million and four promissory notes totaling \$0.50 million. There are three months results of operations included in the three months ended September 30, 2011 and six months results of operations included for the nine months ended September 30, 2011. There are no results of operations included in the three and nine months ended September 30, 2010.

In May 2011, the Company acquired vacant land consisting of approximately 3 acres adjacent to its Sparky's Rialto Self-Storage facility for approximately \$0.4 million paid in cash. The Company intends to use the land for additional motor home parking or for other purposes.

In May 2011, the Company acquired the Dakota Bank Buildings for the purchase price of approximately \$9.6 million. The Property is a six-story, two building office complex built in 1981 and 1986 located on 1.58 and consists of approximately 120,000 rentable square feet acres in downtown Fargo, North Dakota. The Company made a down payment of approximately \$3.875 million and financed the remainder of the purchase price through a monthly adjustable rate mortgage with interest at 3.0% over the one month Libor with an interest rate floor of 5.75% and ceiling of 9.75%. There are three months results of operations included in the three months ended September 30, 2011 and four months results of operations included for the nine months ended September 30, 2011. There are no results of operations included in the three and nine months ended September 30, 2010.

In June 2011, NetREIT Dubose acquired three model home properties in Texas and leased them back to the home builder. The purchase price for the properties was approximately \$0.60 million. NetREIT Dubose paid the purchase price through a cash payment of approximately \$0.30 million and three promissory notes totaling approximately \$0.30 million. There are three months results of operations included in the three months and nine months ended September 30, 2011. There are no results of operations included in the three and nine months ended September 30, 2010.

In August 2011, NetREIT Dubose acquired eight model home properties in Texas, Florida, North Carolina and South Carolina and leased them back to the home builder. The purchase price for the properties was approximately \$1.9 million. NetREIT Dubose paid the purchase price through a cash payment of approximately \$1.0 million and eight promissory notes totaling approximately \$0.90 million. There are one month results of operations included in the three months and nine months ended September 30, 2011. There are no results of operations included in the three and nine months ended September 30, 2010.

In September 2011, the Company acquired the Yucca Valley Retail Center for the purchase price of approximately \$6.8 million. The Property is a neighborhood shopping center complex built in approximately 1978 consisting of five separate parcels. The Property consists of approximately 86,000 rentable square feet and is currently 93% leased and anchored by a national chain grocery store. The Company paid the purchase price through a cash payment of approximately \$3.5 million and assumed a loan secured by the property of approximately \$3.3 million with an interest rate of 5.62%. There is a partial month results of operations included in the three months and nine months ended September 30, 2011. There are no results of operations included in the three and nine months ended September 30, 2010.

The Company disposed of the following properties in 2011:

During the nine months ended September 30, 2011, NetREIT Dubose disposed of eighteen model home properties. The sales price aggregated approximately \$6.6 million and approximately \$4.4 million in mortgage notes payable were retired in connection with these sales.

### ***Financing***

In February 2005, we commenced a private placement offering of up to \$50 million of (i) Series AA Preferred Stock and (ii) units, each unit consisting of two shares of our common stock and a warrant to purchase one share of our common stock at an exercise price of \$12.00 (now \$9.87, as adjusted for stock dividends) exercisable as of the date of issuance and expiring if not exercised on or prior to March 31, 2010. Each Unit was priced at \$20.00 and the Series AA Preferred Stock was priced at \$25.00 per share. A total of 433,204 Units were sold in this offering comprising an aggregate of 433,204 warrants to purchase common stock and 866,408 shares of common stock, and a total of 50,200 shares of the Series AA Preferred Stock were sold in this offering. Each share of Series AA Preferred Stock (i) is non-voting, except under certain circumstances as provided in our Articles of Incorporation; (ii) is entitled to annual cash dividends of 7% which are cumulative and which we pay on a quarterly basis; (iii) ranks senior, as to the payment of dividends and distributions of assets upon liquidation, to common stock or any other series of preferred stock that is not senior to or on parity with the Series AA Preferred Stock; (iv) is entitled to receive \$25.00 plus accrued and unpaid dividends upon liquidation; (v) may be redeemed by us prior to the mandatory conversion date at a price of \$25.00 plus accrued dividends, (vi) may be converted into two shares of common stock at the option of the holder prior to the mandatory conversion date, and, (vii) if not previously redeemed or converted, shall be converted automatically into two shares of common stock on the fourth Friday of December 2015. The conversion price is subject to certain anti dilution adjustments. The Company

redeemed all of the shares outstanding in May 2010 at their face or book value.

In October 2006 we terminated our offering of Series AA Preferred Stock and Units, and we commenced a new offering of up to \$200 million in shares of our common stock at a price of \$10.00 per share. Net proceeds received from these offerings, after commissions, due diligence fees, and syndication expenses, were approximately \$10.2 million in 2010 and \$8.0 million for the nine months ended September 30, 2011. The net proceeds were primarily used to acquire properties and to expand our administrative staff and support capabilities to levels commensurate with our increasing assets and staff requirements. The Company recently announced that capital raising activities under the current offering will close effective December 31, 2011.

**THE FOLLOWING IS A COMPARISON OF OUR RESULTS OF OPERATIONS FOR THE THREE MONTHS ENDED SEPTEMBER 30, 2011 AND 2010.**

***Revenues***

Rental and fee income was \$3,602,792 for the three months ended September 30, 2011, compared to \$2,618,612 for the same period in 2010, an increase of \$984,180, or 37.6%. The increase in rental income as reported in 2011 compared to 2010 is primarily attributable to:

- The addition of the 4 properties acquired in 2010 and 2011 and the addition of the model home properties which generated an additional \$1,027,532 of rent and fee income, including approximately \$85,000 in fee income from the Dubose Partnerships, in the three month period ended September 30, 2011 compared to the same period in 2010; and
- A decrease in the three month period ended September 30, 2011 of \$43,353 for properties owned for the full three month periods in each year primarily due to tenants renewing with new leases at lower rents in our largest office building.

Overall rental and fee revenues are expected to continue to increase in future periods, as compared to historical periods, as a result of owning the assets acquired during 2010 and 2011 for an entire year and future acquisitions of real estate assets.

Interest income was \$54,605 for the three month period ended September 30, 2011, compared to \$24,180 for the same period in 2010, an increase of \$30,425, or 125.8%. The increase was primarily attributable to purchasing a note receivable at a discount in the current year and an increase in cash balances in 2011 that were invested in interest bearing accounts.

***Rental Operating Expenses***

Rental operating expenses were \$1,310,195 for the three month period ended September 30, 2011 compared to \$1,132,908 for the same period in 2010, an increase of \$177,287, or 15.7%. The increase in operating expenses year over year is primarily attributable to the same reasons that rental revenue increased. Rental operating costs as a percentage of rental income was 36.4% and 43.3% for the three months ended September 30, 2011 and 2010, respectively. The decrease in operating costs as a percentage of revenue is primarily due to the addition of the model home properties that are rented on a triple net basis.

Rental operating costs are expected to continue to increase in future periods, as compared to historical periods, as a result of owning recently acquired assets for entire periods and anticipated future acquisitions of real estate assets.

***Interest Expense***

Interest expense, including amortization of deferred finance charges, increased by \$272,445, or 50.6% during the three month period ended September 30, 2011 compared to the same period in 2010. The primary reason for the increase is the mortgage debt additions related to the acquisition of Sparky's Rialto Self-Storage, Genesis Plaza, the Dakota Bank Buildings and the model home properties. In addition, in late June 2011, the Company refinanced its Casa Grande Apartments and Executive Office Park properties to raise additional cash for anticipated acquisitions.

The weighted average interest rate as of September 30, 2011 was 5.64% compared to 5.69% as of September 30, 2010.

The following is a summary of our interest expense on loans by property for the three months ended September 30, 2011 and 2010:

	Date Acquired/Finan ced	2011		2010	
Havana/Parker Complex	June 2006	\$	54,472	\$	55,690
Garden Gateway Plaza	March 2007		146,644		150,621
World Plaza	September 2007		41,521		43,573
Waterman Plaza	August 2008		59,352		60,522
Sparky's Thousand Palms Self-Storage	August 2009		61,518		62,857
Sparky's Hesperia East Self-Storage	December 2009		21,713		21,538
Dubose Acquisition Partners II, LP	March 2010		29,250		45,282
Dubose Acquisition Partners III, LP	March 2010		17,285		28,162
Sparky's Rialto Self-Storage	May 2010		36,392		37,152
Genesis Plaza	August 2010		56,972		24,471
Dubose Model Home Income Fund #3, LTD (1)	December 2010		(21,520)		-
Dubose Model Home Income Fund #4, LTD (1)	December 2010		(11,186)		-
Dubose Model Home Income Fund #5, LTD	December 2010		30,465		-
NetREIT Dubose Model Home REIT, Inc.	October 2010		73,120		-
Dakota Bank Buildings	May 2011		83,512		-
Casa Grande Apartments	June 2011		15,329		-
Executive Office Park	June 2011		67,070		-
Yucca Valley Retail Center	September 2011		6,753		-
Amortization of deferred financing costs			41,846		8,195
		\$	<u>810,508</u>	\$	<u>538,063</u>

(1) Interest rates on several mortgage notes payable were reduced retroactively in the current quarter.

### ***General and Administrative Expenses***

General and administrative expenses increased by \$9,926 to \$791,655 for the three months ended September 30, 2011, compared to \$781,729 in the same period in 2010. As a percentage of rental and fee income, general and administrative expenses were down to 22.0% for the three months ended September 30, 2011, from 29.9% for the same three months in 2010. We anticipate that general and administrative expenses will continue to decline as a percentage of rental and fee income.

For the three months ended September 30, 2011, our salaries and employee related expenses decreased by approximately \$38,000 to \$463,000 compared to \$501,000 for the same three months in 2010, a decrease of 9.9%. The decrease in salary and employee expenses in three month period in 2011 was primarily attributable to retention bonuses paid to former DMHU employees for staying through transition of responsibilities.

Legal, accounting and public company related expenses decreased by approximately \$20,000 to \$58,000 for the three month period ended September 30, 2011, compared to \$78,000 during the same period in 2010. The decrease is primarily higher costs incurred in the prior year for the Maryland reincorporation and formation costs associated with the start-up of NetREIT Advisors and NetREIT Dubose entities.

Insurance related expenses, including group health increased by approximately \$12,000 to \$59,000 for the three month period ended September 30, 2011 compared to approximately \$47,000 for the same period in 2010. The increase is also attributable to the overall growth of the Company as well as general rate increases, particularly in group health insurance costs.

Other increases to general and administrative costs include increased acquisition costs related to the model home properties and increases in office and related expenses due to the overall growth of the Company.

### ***Loss on Sale of Real Estate Assets***

In the three month period ended September 30, 2011, the Company had losses on the sale of three model home properties attributable to the Dubose Partnerships of \$32,424. The loss for the quarter is considered unusual and is a result of the timing of certain sales. The Dubose Partnerships have 79 model home properties and currently has an immaterial amount of homes held for sale.

### ***Net Loss***

Net loss for the three months ended September 30, 2011 was \$417,597, or \$0.03 loss per share, compared to a net loss for the three months ended September 30, 2010 of \$750,828, or \$0.07 loss per share. The decrease in net loss of \$333,231 in the three month period ended September 30, 2011 was primarily attributable to increased net operating income of our properties.

Net loss before depreciation and amortization, including amortization of above market rents, was income of \$743,524 for the three months ended September 30, 2011, compared to income of \$129,196 for the same three months in 2010, an increase of \$614,328.

**THE FOLLOWING IS A COMPARISON OF OUR RESULTS OF OPERATIONS FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2011 AND 2010.**

***Revenues***

Rental and fee income was \$10,227,245 for the nine months ended September 30, 2011, compared to \$7,091,847 for the same period in 2010, an increase of \$3,135,398, or 44.2%. The increase in rental income as reported in 2011 compared to 2010 is primarily attributable to:

- The addition of the four properties acquired in 2010 and 2011 and the addition of the model home properties which generated an additional \$3,074,792 million of rent and fee income, including approximately \$245,000 in fee income from the Dubose Partnerships, in the nine month period ended September 30, 2011 compared to the same period in 2010; and

- Rental and fee income increased by approximately \$60,000 for properties owned for the full nine months ended September 30, 2011 and 2010.

Overall rental and fee revenues are expected to continue to increase in future periods, as compared to historical periods, as a result of owning the assets acquired during 2010 and 2011 for an entire year and future acquisitions of real estate assets.

Interest income was \$102,196 for the nine month period ended September 30, 2011, compared to \$78,937 for the same period in 2010, an increase of \$23,259, or 29.4%. The increase is attributable to the purchase of notes receivable early in 2011 offset slightly by a decrease in cash balances in 2011 that were invested in interest bearing accounts.

***Rental Operating Expenses***

Rental operating expenses were \$3,659,173 for the nine month period ended September 30, 2011 compared to \$3,192,549 for the same period in 2010, an increase of \$466,624, or 14.6%. The increase in operating expense year over year is primarily attributable to the same reasons that rental revenue increased except for the model home properties which are rented on a triple net basis. Rental operating costs as a percentage of rental and fee income was 35.8% and 45.0% for the nine months ended September 30, 2011 and 2010, respectively. The decrease in operating costs as a percentage of revenue is primarily due to the addition of the model home properties that are rented on a triple net basis.

Rental operating costs are expected to continue to increase in future periods, as compared to historical periods, as a result of owning recently acquired assets for entire periods and anticipated future acquisitions of real estate assets.

***Interest Expense***

Interest expense, including amortization of deferred finance charges, increased by \$892,468 in the nine month period ending September 30, 2011, to \$2,306,595, compared to \$1,414,127 for the same period in 2010, an increase of 63.1% during the nine month period ended September 30, 2011 compared to the same period in 2010. The primary reason for the increase is the mortgage debt additions related to the acquisition of Sparky's Rialto Self-Storage, Genesis Plaza, the Dakota Bank Buildings and the model home properties. In addition, the Company refinanced its Casa Grande and Executive Office Park properties to raise additional cash for anticipated acquisitions.

The weighted average interest rate as of September 30, 2011 was 5.64% compared to 5.69% as of September 30, 2010.

The following is a summary of our interest expense on loans by property for the nine months ended September 30, 2011 and 2010:

	Date Acquired/Finan ced	Date	
		2011	2010
Havana/Parker Complex	June 2006	\$ 162,553	\$ 166,109
Garden Gateway Plaza	March 2007	442,967	403,777
	September		
World Plaza	2007	126,124	132,196
Waterman Plaza	August 2008	178,950	182,403
Sparky's Thousand Palms Self-Storage	August 2009	185,573	189,544
	December		
Sparky's Hesperia East Self-Storage	2009	64,681	66,165
Dubose Acquisition Partners II, LP	March 2010	100,621	103,819
Dubose Acquisition Partners III, LP	March 2010	76,449	65,839
Sparky's Rialto Self-Storage	May 2010	108,543	58,651
Genesis Plaza	August 2010	171,870	24,471
	December		
Dubose Model Home Income Fund #3, LTD	2010	49,843	-
	December		
Dubose Model Home Income Fund #4, LTD	2010	35,655	-
	December		
Dubose Model Home Income Fund #5, LTD	2010	102,988	-
NetREIT Dubose Model Home REIT, Inc.	Various	183,647	-
Dakota Bank Buildings	May 2011	116,287	-
Casa Grande Apartments	June 2011	18,165	-
Executive Office Park	June 2011	77,285	-
	September		
Yucca Valley Retail Center	2011	6,755	
Amortization of deferred financing costs		97,639	21,153
		<u>\$ 2,306,595</u>	<u>\$ 1,414,127</u>

### ***General and Administrative Expenses***

General and administrative expenses increased by \$306,678 to \$2,656,195 for the nine months ended September 30, 2011, compared to \$2,349,517 in the same period in 2010. As a percentage of rental and fee income, general and administrative expenses were down to 26.0% for the nine months ended September 30, 2011, from 33.1% for the same nine months in 2010. In comparing our general and administrative expenses with other REITs, you should take into consideration that we are a self administered REIT, which means such expenses are greater for us than an advisory administered REIT.

For the nine months ended September 30, 2011, our salaries and employee related expenses increased approximately \$203,000 to \$1,572,000 compared to \$1,369,000 for the same nine months in 2010, an increase of 14.8%. The increase in salary and employee expenses in 2011 was primarily attributable to the addition of the employees associated with the Dubose Partnerships in March 2010 and additional stock based compensation expense of approximately \$59,000. In addition, the Company annually grants salary increases to employees effective January 1 each year.

Legal, accounting and public company related expenses decreased by approximately \$80,000 to \$317,000 for the nine month period ended September 30, 2011, compared to \$397,000 during the same period in 2010. The decrease is primarily due to the costs associated with the Company's efforts to reincorporate in Maryland in 2010.

Insurance related expenses, including group health insurance, increased by approximately \$52,000 to \$188,000 for the nine month period ended September 30, 2011 compared to \$136,000 for the same period in 2010. The increase is also attributable to the overall growth of the Company as well as general rate increases.

Other increases to general and administrative costs include increased acquisition costs related to the model home properties and the three property acquisitions this year as well as increases in office and related expenses due to the overall growth of the Company.

### ***Loss on Sale of Real Estate Assets***

In the nine month period ended September 30, 2011, the Company had a loss on the sale of model home properties attributable to the Dubose Partnerships of \$56,911. The loss year-to-date is considered unusual and is a result of the timing of certain sales. The Dubose Partnerships have 79 model home properties and currently has an immaterial amount of homes held for sale, which if they were all sold in the same period, would result in a net gain.

### ***Net Loss***

Net loss for the nine months ended September 30, 2011 was \$1,686,801, or \$0.13 loss per share, compared to a net loss for the nine months ended September 30, 2010 of \$2,520,665, or \$0.23 loss per share. The decrease in net loss of \$833,864 in the nine month period ended September 30, 2011 was primarily attributable to increased net operating income of our properties, offset by increases to interest expense, depreciation and amortization expenses and general and administrative expenses.

Net loss before depreciation and amortization, including amortization of above market rents, was income of \$1,544,644 for the nine months ended September 30, 2011, compared to income of \$60,969 for the same nine months in 2010, an increase of \$1,483,695.

## **LIQUIDITY AND CAPITAL RESOURCES**

As discussed above under Economic Outlook, during 2011, there have been indications of economic improvement and stabilization in the equity markets. However, we expect the market turbulence could continue in the commercial real estate arena as mortgage financing originated over the past three to seven years mature.

We believe that as a result of these negative trends, new mortgage financing will be less favorable as pre-recession days, which may negatively impact our ability to finance future acquisitions. Long-term interest rates remain relatively low by historical standards but we anticipate that interest rates will increase in the next couple of years. On the other hand, we believe the negative trends in the mortgage markets for smaller properties and in some geographic locations have reduced property prices and may, in certain cases, reduce competition for those properties.

### ***Overview***

We actively seek investments that are likely to produce income in order to pay distributions as well as long-term gains for our stockholders. Our future sources of liquidity include cash and cash equivalents, cash flows from operations, mortgages on our unencumbered properties and additional equity securities from our ongoing private placement offering.

Our future capital needs include the acquisition of additional properties as we expand our investment portfolio into other real property sectors, pay down outstanding borrowings and the payment of a competitive distribution to our shareholders. To ensure that we are able to effectively execute these objectives, we routinely review our liquidity requirements and continually evaluate all potential sources of liquidity. Our short term liquidity needs include proceeds necessary to pay the debt service on existing mortgages, fund our current operating costs and fund our distribution to stockholders. Our long-term liquidity needs include proceeds necessary to grow and maintain our portfolio of investments.

We believe that our available liquidity is sufficient to fund our distributions to stockholders, pay the debt service costs on our existing mortgages and fund our operating costs in the near term. We further believe that our cash flow from operations along with the potential financing capital available to us in the future is sufficient to fund our long-term liquidity needs. However, we do not expect that our cash flow from operating activities will be totally sufficient to fund our short term liquidity needs, including the payment of cash dividends at current rates to our shareholders, and instead we expect to fund a portion of these needs from additional borrowings of secured or unsecured indebtedness, and from proceeds of the ongoing private placement of common stock. We expect to obtain additional mortgages and assumption of existing debt collateralized by some or all of our real property in the future. During the second quarter ended June 30, 2011, we obtained approximately \$5.7 million from new mortgages collateralized by two of our unencumbered properties and we expect to obtain additional mortgages collateralized by two of the seven unencumbered existing properties during the fourth quarter of 2011. During the nine months ended September 30, 2011, we received approximately \$8.0 million of cash from net proceeds in connection with our private placement offering and we anticipate raising approximately \$5 million additional capital during the remainder of 2011.

### ***Cash and Cash Equivalents***

At September 30, 2011, we had approximately \$5.2 million in cash and cash equivalents compared to approximately \$7.0 million at December 31, 2010. We intend to use this cash to make additional acquisitions, pay debt service costs on our existing mortgages and for general corporate purposes.

Our cash and cash equivalents are held in bank accounts at third party institutions and consist of invested cash and cash in our operating accounts. During 2010 or 2011, we did not experience any loss or lack of access to our cash or cash equivalents.

## ***Debt***

As of September 30, 2011, the Company had mortgage notes payables in the aggregate principal amount of \$48.1 million, collateralized by a total of 12 non model home properties with terms at issuance ranging from 3 to 30 years. The weighted-average interest rate on the mortgage notes payable as of September 30, 2011 was approximately 5.68%. Our debt to book value on these properties is approximately 61% and we have eight non model home properties with a net book value of \$30.1 million that are unencumbered. We have mortgage debt balloon principal payments on one mortgage of approximately \$3.1 million in 2012. We have arranged to refinance this balloon payment in the fourth quarter of 2011 at a lower interest rate. Despite the disruptions in the debt market discussed in "Overview" above, we believe that we will be able to refinance these debts as they come due if we so desire.

As of September 30, 2011, NetREIT Dubose had 48 fixed-rate mortgage notes payable in the aggregate principal amount of \$5.4 million, collateralized by a total of 48 model home properties, an average of \$113,300 per home. These loans generally have a term at issuance of five years. The weighted-average interest rate on these mortgage notes payable as of September 30, 2011 was 5.64%. Our debt to net book value on these properties is approximately 49.4%. The Company has guaranteed these notes. The balloon principal payments on the notes payable are in 2015 and 2016.

As of September 30, 2011, limited partnerships that the Company has a limited partnership interest in had 31 fixed-rate mortgage note payables in the aggregate principal amount of \$5 million, collateralized by a total of 31 model home properties, an average of \$162,000 per home. The debt to book value on these properties is approximately 49.2%. All of these notes payable have mortgage debt balloon principal payments in 2011. All of the free cash flow on these limited partnerships is being held or applied to the loan balances with no distribution to the partners until all homes have been sold. All of the properties will be sold at the end of the lease agreements and we believe that all properties will be sold for more than the mortgage debt balloon amount.

During the second quarter of 2011, we financed one acquisition with approximately 50% debt provided by a regional bank and we obtained approximately \$5.7 million new financing from a life insurance company on two unencumbered properties for approximately 50% their appraised values. During the third quarter of 2011, we acquired a property and assumed an existing loan secured by that property for approximately \$3.3 million which was slightly less than 50% of the purchase price. Despite the disruptions in the debt market discussed in "Overview" above, we believe that we will be able to refinance maturing debts as on or before maturity dates.

## ***Operating Activities***

Net cash provided by operating activities for the nine months ended September 30, 2011 was approximately \$1.4 million, respectively, compared to net cash used in operating activities of approximately \$109,000 for the nine months ended September 30, 2010. The increase during the nine months of approximately \$1.5 million was primarily due to an increase in net operating income of our properties of approximately \$1.5 million and an increase of approximately \$819,000 from contributions in excess of distributions of non-controlling interests less an increase in working capital of approximately \$878,000. Although the cash from operating activities did not cover the cash portion of the distribution to our stockholders of approximately \$2.6 million, we anticipate that with the inclusion of the recent acquisitions and the anticipated acquisitions that the cash provided by operating activities will cover the cash distribution to shareholders in the near future.

## ***Investing Activities***

Net cash used in investing activities was approximately and \$17.3 million during the nine months ended September 30, 2011. During this period, the Company acquired the Dakota Bank Buildings for \$9.6 million, acquired raw land adjacent to our Sparky's Rialto Self-Storage facility for approximately \$0.4 million and acquired the Yucca Valley Retail center for approximately \$6.8 million. In addition, we spent approximately \$0.8 million on capital expenditures of existing properties. Furthermore, during this period, NetREIT Dubose acquired 23 homes for \$5.6 million. The Dubose Partnerships sold 18 model homes during the period for proceeds of \$6.6 million.

Net cash used in investing activities for the nine months ended September 30, 2010 was approximately \$15.9 million. During this period in 2010 the Company acquired two properties for \$14.9 million, spent \$0.7 million in capital expenditures and paid \$300,000 to purchase DMHU.

### **Financing Activities**

Net cash provided by financing activities for the nine months ended September 30, 2011 was approximately \$14.1 million. The financing activities consisted of approximately \$8.0 million net proceeds from the issuance of our common stock and proceeds from mortgage notes payable of \$17.5 million. The proceeds were offset by reduction in mortgage notes payable of \$8.2 million (\$4.4 million in connection with the sale of the 18 model homes), cash distributions to shareholders of \$2.6 million, repurchase of common stock of \$0.4 million and increase in deferred stock issuance costs of \$0.2 million.

Net cash provided by financing activities for the nine months ended September 30, 2010 was approximately \$13.7 million, which consisted of approximately \$10.2 million net proceeds from the sale and issuance of our common stock and approximately \$7.9 million in proceeds from mortgage notes payable used to finance the acquisition of two properties. These proceeds were offset by payments on mortgage notes payable, the redemption of preferred stock and distributions to stockholders of approximately \$0.7, \$1.3 and \$2.1 million, respectively.

### **Contractual Obligations**

The following table provides information with respect to the maturities and scheduled principal repayments of our secured debt and interest payments on our fixed-rate debt at September 30, 2011 and provides information about the minimum commitments due in connection with our ground lease obligation. Our secured debt agreements contain covenants and restrictions requiring us to meet certain financial ratios and reporting requirements. Non-compliance with one or more of the covenants or restrictions could result in the full or partial principal balance of such debt becoming immediately due and payable.

We are in compliance with all conditions and covenants of our loans.

	Less than		More than		
	a year	1-3 Years	3-5 Years	5 Years	Total
	2011	(2012-2013)	(2014-2015)	(After 2015)	Total
Principal payments - secured debt	\$ 220,362	\$ 5,195,595	\$ 23,791,263	\$ 18,897,416	\$ 48,104,636
Interest payments - fixed rate debt	606,268	4,021,876	2,627,443	979,910	8,235,497
Interest payments - variable rate debt	151,134	1,114,397	1,062,297	2,458,691	4,786,519
Model home properties - secured debt	2,153,716	3,594,253	2,591,982	2,123,577	10,463,528
Model home properties - interest payments	157,922	394,504	334,887	10,160	897,473
Ground lease obligation (1)	5,010	43,064	43,820	1,093,383	1,185,277
	<u>\$ 3,294,412</u>	<u>\$ 14,363,689</u>	<u>\$ 30,451,692</u>	<u>\$ 25,563,137</u>	<u>\$ 73,672,930</u>

(1) Ground lease obligation represents the ground lease payments due on our World Plaza Property.

### **Other Liquidity Needs**

We are required to distribute 90% of our REIT taxable income (excluding capital gains) on an annual basis in order to qualify and maintain our qualification as a REIT for federal income tax purposes. Accordingly, we intend to continue to make regular quarterly distributions to our common shareholders from cash flow from operating activities. We are not contractually bound to make regular quarterly dividend distributions to our common stock holders. We may be required to use borrowings or other sources of capital, if necessary, to meet REIT distribution requirements and maintain our REIT status. In the past, as noted above, we have distributed cash amounts in excess of our taxable income resulting in a return of capital to our shareholders, and we currently have the ability to refrain from increasing our distributions while still meeting our REIT requirement for 2011. If our net cash provided by operating activities and gains on sale of real estate (assuming we are successful in selling any of our properties)

do not exceed our intended distributions to our common shareholders, we would have to borrow funds or use proceeds of our ongoing common stock offering to pay the distribution or reduce or eliminate the distribution. We consider market factors and our historical and anticipated performance in addition to REIT requirements in determining our distribution levels.

Until proceeds from our offering are fully invested and our acquired properties are generating operating cash flow sufficient to fully cover distributions to our shareholders, we intend to pay a portion of the distributions to our shareholders from the proceeds of our ongoing common stock private placement offering or from borrowings in anticipation of future cash flows, as deemed appropriate.

### ***Capitalization***

As of September 30, 2011, our consolidated total debt as a percentage of total capitalization was 30.0% and our total debt as a percentage of total capitalization excluding the model home properties was 24.6%, which was calculated based on the offering price per share of our common stock of \$10.00 under our ongoing current private placement of our common stock.

	Shares at September 30, 2011	Aggregate Principal Amount or \$ Value Equivalent	% of Total Market Capitalization
<b>Debt:</b>			
NetREIT, Inc. debt		\$ 48,104,636	24.64%
Model home properties debt		10,463,528	5.36%
Total debt		\$ 58,568,164	30.00%
<b>Equity:</b>			
Common stock outstanding (1)	13,665,722	136,657,220	70.00%
Total Market Capitalization		\$ 195,225,384	

(1) Value based on the current price of shares being sold under the current private placement offering of \$10.00 per share.

### ***Off-Balance Sheet Arrangements***

As of September 30, 2011 and 2010, we do not have any off-balance sheet arrangements or obligations, including contingent obligations.

### ***Capital Expenditures, Tenant Improvements and Leasing Costs***

We currently project that during 2011 we could spend an additional \$125,000 to \$500,000 in capital improvements, tenant improvements, and leasing costs for properties within our portfolio. Capital expenditures may fluctuate in any given period subject to the nature, extent, and timing of improvements required to the properties. We may spend more on gross capital expenditures during 2011 compared to 2010 due to rising construction costs and the anticipated increase in property acquisitions in 2011. Tenant improvements and leasing costs may also fluctuate in any given year depending upon factors such as the property, the term of the lease, the type of lease, the involvement of external leasing agents and overall market conditions.

## Non-GAAP Supplemental Financial Measure: Funds From Operations (“FFO”)

Management believes that FFO is a useful supplemental measure of our operating performance. We compute FFO using the definition outlined by the National Association of Real Estate Investment Trusts (“NAREIT”). NAREIT defines FFO as net income (loss) in accordance with GAAP, plus depreciation and amortization of real estate assets (excluding amortization of deferred financing costs and depreciation of non-real estate assets) reduced by gains and losses from sales of depreciable operating property and extraordinary items, as defined by GAAP. Other REITs may use different methodologies for calculating FFO and, accordingly, our FFO may not be comparable to other REITs. Because FFO excludes depreciation and amortization, gains and losses from property dispositions that are available for distribution to shareholders and extraordinary items, it provides a performance measure that, when compared year over year, reflects the impact to operations from trends in occupancy rates, rental rates, operating costs, development activities, general and administrative expenses and interest costs, providing a perspective not immediately apparent from net income. In addition, management believes that FFO provides useful information to the investment community about our financial performance when compared to other REITs since FFO is generally recognized as the industry standard for reporting the operations of REITs. However, FFO should not be viewed as an alternative measure of our operating performance since it does not reflect either depreciation and amortization costs or the level of capital expenditures and leasing costs necessary to maintain the operating performance of our properties that are significant economic costs and could materially impact our results from operations.

The following table presents our FFO for the three months and nine months ended September 30, 2011 and 2010. FFO should not be considered an alternative to net income (loss), as an indication of our performance, nor is FFO indicative of funds available to fund our cash needs or our ability to make distributions to our shareholders. In addition, FFO may be used to fund all or a portion of certain capitalizable items that are excluded from FFO, such as capital expenditures and payments of debt, each of which may impact the amount of cash available for distribution to our shareholders.

	Three months ended September 30,		Nine months ended September 30,	
	2011	2010	2011	2010
Net loss before noncontrolling interests	\$ (342,410)	\$ (689,932)	\$ (1,385,496)	\$ (2,330,827)
Adjustments:				
Preferred Stock Dividends	-	-	-	(34,447)
Income attributable to noncontrolling interests	(75,187)	(60,896)	(301,305)	(155,391)
Depreciation and amortization	1,161,121	880,024	3,231,465	2,547,187
Loss on sale of real estate assets	32,424	-	56,911	-
Funds from Operations	<u>\$ 775,948</u>	<u>\$ 129,196</u>	<u>\$ 1,601,575</u>	<u>\$ 26,522</u>

FFO for 2011 increased in the three month period ended September 30, 2011 by \$646,752, to \$775,948 compared to FFO of \$129,196 for the same period in 2010. For the nine months ended September 30, 2011, FFO increased by \$1,575,053 to \$1,601,575 compared to FFO of \$26,522 for the nine months ended September 30, 2010. The increased FFO is primarily due to the increase in performance of the properties especially those acquired in 2009 and 2010 with a smaller increase in general and administrative expenses.

FFO has been affected by lower yields on our investment of excess cash balances. We anticipate FFO to improve as we continue to acquire properties and earn rental revenues on properties recently acquired without substantial increases in general and administrative expenses.

### ***Inflation***

Since the majority of our leases require tenants to pay most operating expenses, including real estate taxes, utilities, insurance and increases in common area maintenance expenses, we do not believe our exposure to increases in costs and operating expenses resulting from inflation would be material.

### ***Segments Disclosure***

Our reportable segments consist of mortgage activities and the four types of commercial real estate properties for which our decision-makers internally evaluate operating performance and financial results: Residential Properties, including Model Homes, Office Properties, Retail Properties and Self-Storage Properties. We also have certain corporate level activities including accounting, finance, legal administration and management information systems which are not considered separate operating segments.

Our chief operating decision maker evaluates the performance of our segments based upon net operating income. Net operating income is defined as operating revenues (rental income, tenant reimbursements and other property income) less property and related expenses (property expenses, real estate taxes, ground leases and provisions for bad debts) and excludes other non-property income and expenses, interest expense, depreciation and amortization, and general and administrative expenses. There is no intersegment activity.

See the accompanying financial statements for a Schedule of the Segment Reconciliation to Net Income Available to Common Shareholders.

### **ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

Not required

### **ITEM 4. CONTROLS AND PROCEDURES**

NetREIT maintains disclosure controls and procedures that are designed to ensure that information required to be disclosed in the Company's Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to the Company's management, including its Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure based closely on the definition of "disclosure controls and procedures" in Rule 13a-14(c). In designing and evaluating the disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

As of the end of the period covered by this report, we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and our Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of the end of the period covered by this report.

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

There were no changes in our internal control over financial reporting that occurred during the fiscal quarter ended September 30, 2011 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

## PART II — OTHER INFORMATION

### Item 1. Legal Proceedings. –

None.

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

During the nine months ended September 30, 2011, the Company sold 980,295 shares of its common stock for an aggregate net proceeds of approximately \$8.0 million. These shares were sold at a price of \$10.00 per share in a private placement offering to a total of 180 accredited investors. Each issuee purchased their shares for investment and the shares are subject to appropriate transfer restrictions. The private placement offering was made by the Company through selected FINRA member broker-dealer firms. The sales were made in reliance on the exemptions from registration under the Securities Act of 1933 and applicable state securities laws contained in Section 4(2) of the Act and Rule 506 promulgated thereunder.

During the nine months ended September 30, 2011, the Company also sold 200,599 shares of its common stock to certain of its existing shareholders under its dividend reinvestment plan. The shares were sold directly by the Company without underwriters to a total of 1,519 persons participating in the plan. The Company sold these shares in reliance on the exemptions from registration under the Securities Act of 1933 and applicable state securities laws set forth in Section 4(2) of the Act and Rule 506 promulgated thereunder. Each issuee purchased the shares for investment and the shares are subject to appropriate transfer restrictions.

All shares issued in these offerings were sold for cash consideration. The Company used the net proceeds it received for the sale of these shares to acquire and/or maintain its real estate investments

### Issuer Purchases of Equity Securities

<u>Period</u>	<u>(a) Total Number of Shares Purchased</u>	<u>(b) Average Price Paid per Share</u>	<u>(c) Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs (1)</u>	<u>(d) Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs (1)</u>
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(1) The Company does not have a formal policy with respect to a stock repurchase program and typically limits repurchases to hardship cases only.

### Item 3. Defaults Upon Senior Securities.

None.

### Item 4. <Removed and Reserved>

### Item 5. Other Information.

None.

**ITEM 6. EXHIBITS.**

<b>Exhibit Number</b>	<b>Description</b>
<a href="#">31.1</a>	Certificate of the Company's Chief Executive Officer (Principal Executive Officer) pursuant to Section 302 of the Sarbanes-Oxley Act of 2002, with respect to the registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2011.
<a href="#">31.2</a>	Certification of the Company's Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002, with respect to the registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2011.
<a href="#">31.3</a>	Certification of the Company's Principal Financial and Accounting Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002, with respect to the registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2011.
<a href="#">32.1</a>	Certification of principal executive officer and principal financial officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101.INS	Instance Document
101.SCH	XBRL Taxonomy Extension Schema Document
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB	XBRL Taxonomy Extension Label Linkbase Document
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document

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## 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 thereunto duly authorized.

Date: November 14, 2011

NetREIT, Inc.

By: */s/ Jack K. Heilbron*

\_\_\_\_\_  
Name: Jack K. Heilbron  
Title: Chief Executive Officer

By: */s/ Kenneth W. Elsberry*

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Name: Kenneth W. Elsberry  
Title: Chief Financial Officer

By: */s/ J. Bradford Hanson*

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Name: J. Bradford Hanson  
Title: Principal Financial and Accounting Officer

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EXHIBIT 31.1

### CERTIFICATION OF CHIEF EXECUTIVE OFFICER PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002

I, Jack K. Heilbron, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of NetREIT, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the issuer as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this

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report based on such evaluation;

- (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has material affected, or is reasonably likely to materially effect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
- (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 14, 2011

By: /s/ Jack K. Heilbron  
Jack K. Heilbron,  
Chief Executive Officer

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EXHIBIT 31.2

CERTIFICATION OF CHIEF FINANCIAL  
OFFICER PURSUANT TO SECTION 302  
OF THE SARBANES-OXLEY ACT OF 2002

I, Kenneth W. Elsberry, certify that:

- 1. I have reviewed this Quarterly Report on Form 10-Q of NetREIT, Inc.;
- 2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
- 3. Based on my knowledge, the financial statements and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the issuer as of, and for, the periods presented in this report;
- 4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation;
  - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the

registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has material affected, or is reasonably likely to materially effect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 14, 2011

By: /s/ Kenneth W. Elsberry  
Kenneth W. Elsberry,  
Chief Financial Officer

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EXHIBIT 31.3

CERTIFICATION OF PRINCIPAL FINANCIAL  
AND ACCOUNTING OFFICER PURSUANT TO SECTION 302  
OF THE SARBANES-OXLEY ACT OF 2002

I, J. Bradford Hanson, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of NetREIT, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the issuer as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation;
  - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has material affected, or is reasonably likely to materially effect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
- (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 14, 2011

By: /s/ J. Bradford Hanson  
J. Bradford Hanson,  
Principal Financial and Accounting Officer

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EXHIBIT 32.1

CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350  
AS ADOPTED PURSUANT TO SECTION 906  
OF THE SARBANES-OXLEY ACT OF 2002

Each of the undersigned hereby certifies, pursuant to 18 U.S.C. Section 1350, in their capacities as CEO, CFO and Principal Financial and Accounting Officer, respectively, of NetREIT, Inc. (the "**Company**") that, to the best of his knowledge:

- (i) the Quarterly Report for the quarter ended September 30, 2011 of the Company on Form 10-Q (the "**Report**") fully complies with the requirements of Section 13(a) of the Securities Exchange Act of 1934, as amended; and
- (ii) the information contained in the Report fairly presents, in all material respects, the financial condition and the results of operations of the Company.

Date: November 14, 2011

By: /s/ Jack K. Heilbron  
Jack K. Heilbron,  
Chief Executive Officer

Date: November 14, 2011

By: /s/ Kenneth W. Elsberry  
Kenneth W. Elsberry,  
Chief Financial Officer

Date: November 14, 2011

By: /s/ J. Bradford Hanson  
J. Bradford Hanson  
Principal Financial and Accounting Officer

A signed original of this written statement required by Section 906, or other document authenticating, acknowledging, or otherwise adopting the signature that appears in typed form within the electronic version of this written statement required by Section 906, has been provided to NetREIT, Inc. and will be retained by NetREIT, Inc. and furnished to the Securities and Exchange Commission or its staff upon request.

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