Section 1: 10-Q (10-Q)

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2018

OR

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

For the transition period from to

Commission file number 000-55580

HIGHLANDS REIT, INC.

(Exact Name of Registrant as Specified in Its Charter)

Maryland	**81-0862795**
(State or Other Jurisdiction of Incorporation or Organization)	**(I.R.S. Employer Identification No.)**
332 S Michigan Avenue, Ninth Floor Chicago, Illinois	**60604**
(Address of Principal Executive Offices)	**(Zip Code)**

(312) 583-7990
(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 every Interactive Data File required to be submitted 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 such files). ☑ Yes ☐ No

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

Large accelerated filer	Accelerated filer	Non-accelerated filer	Smaller reporting company	Emerging Growth Company
			☑	☑

☐ ☐ ☐

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

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

As of November 6, 2018 there were 871,537,188 shares of the registrant’s common stock outstanding.

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HIGHLANDS REIT, INC. AND ITS PREDECESSORS

Condensed Consolidated Balance Sheets
(Amounts in thousands, except share and per share amounts)

	September 30, 2018 (Unaudited)	December 31, 2017
Assets		
Investment properties		
Land	$ 74,447	$ 79,163
Building and other improvements	297,937	296,204
Construction in progress	1,917	483
Total	374,301	375,850
Less accumulated depreciation	(105,927)	(109,928)
Net investment properties	268,374	265,922
Cash and cash equivalents	41,993	53,852
Restricted cash and escrows	2,020	2,155
Accounts and rents receivable (net of allowance of $1,047 and $850, respectively)	6,042	4,897
Intangible assets, net	617	561
Deferred costs and other assets	3,738	2,230
Total assets	$ 322,784	$ 329,617
Liabilities		
Mortgage loans, net	$ 35,088	$ 55,273
Accounts payable and accrued expenses	10,664	11,048
Intangible liabilities, net	3,106	3,413
Other liabilities	1,955	1,786
Total liabilities	$ 50,813	$ 71,520
Commitments and contingencies (Note 13)		
Stockholders' Equity		
Common stock, $0.01 par value, 1,000,000,000 shares authorized, 871,537,188 and 868,423,581 shares issued and outstanding as of September 30, 2018 and December 31, 2017, respectively	8,715	8,684
Additional paid-in capital	1,407,454	1,406,460
Accumulated distributions in excess of net income	(1,144,198)	(1,157,047)
Total stockholders' equity	271,971	258,097
Total liabilities and stockholders' equity	$ 322,784	$ 329,617

See accompanying notes to the condensed consolidated financial statements.

HIGHLANDS REIT, INC. AND ITS PREDECESSORS

Condensed Consolidated Statements of Operations (unaudited)
(Amounts in thousands, except share and per share amounts)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	**2017**	**2018**	**2017**
Revenues				
Rental income	$ 9,323	$ 10,901	$ 26,401	$ 38,260
Tenant recovery income	2,123	1,973	5,991	5,640
Other property income	203	129	725	823
Total revenues	$ 11,649	$ 13,003	$ 33,117	$ 44,723
Expenses				
Property operating expenses	2,353	2,395	6,648	8,383
Real estate taxes	1,388	1,352	3,628	5,908
Depreciation and amortization	3,406	3,288	9,753	13,788
General and administrative expenses	2,594	2,089	9,776	8,763
Provision for asset impairment	—	485	—	1,197
Total expenses	$ 9,741	$ 9,609	$ 29,805	$ 38,039
Operating income	$ 1,908	$ 3,394	$ 3,312	$ 6,684
Interest income	81	18	371	75
Gain (loss) on sale of investment properties	12,276	(29)	12,301	(32)
(Loss) gain on extinguishment of debt	(1,199)	77,466	(1,199)	194,366
Other income	23	1,489	23	1,492
Interest expense	(700)	(1,542)	(2,114)	(13,230)
Income before income taxes	$ 12,389	$ 80,796	$ 12,694	$ 189,355
Income tax benefit	—	—	155	7
Net income	$ 12,389	$ 80,796	$ 12,849	$ 189,362
Net income per common share, basic and diluted	$ 0.01	$ 0.09	$ 0.01	$ 0.22
Weighted average number of common shares outstanding, basic and diluted	871,537,188	868,423,581	871,027,452	867,439,543

See accompanying notes to the condensed consolidated financial statements.

HIGHLANDS REIT, INC. AND ITS PREDECESSORS

Condensed Consolidated Statements of Equity (unaudited)
(Amounts in thousands, except share amounts)

Nine months ended September 30, 2018 and 2017

	Common Stock		Additional Paid-in Capital	Accumulated Distributions in Excess of Net Income	Total
	Shares	Amount			
Balance at January 1, 2017	864,890,967	$ 8,649	$ 1,405,677	$ (1,331,046)	$ 83,280
Net income	—	—	—	189,362	189,362
Share-based compensation	3,532,614	35	783	—	818
Balance at September 30, 2017	868,423,581	$ 8,684	$ 1,406,460	$ (1,141,684)	$ 273,460
Balance at January 1, 2018	868,423,581	$ 8,684	$ 1,406,460	$ (1,157,047)	$ 258,097
Net income	—	—	—	12,849	12,849
Share-based compensation	3,229,941	32	1,034	—	1,066
Common stock repurchased and retired	(116,334)	(1)	(40)	—	(41)
Balance at September 30, 2018	871,537,188	$ 8,715	$ 1,407,454	$ (1,144,198)	$ 271,971

See accompanying notes to the condensed consolidated financial statements.

HIGHLANDS REIT, INC. AND ITS PREDECESSORS
Condensed Consolidated Statements of Cash Flow (unaudited)
(Amounts in thousands)

	Nine Months Ended September 30,	
	2018	2017
Cash flows from operating activities:		
Net income	$ 12,849	$ 189,362
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	9,753	13,813
Amortization of above and below market leases, net	(307)	(314)
Amortization of debt discounts and financing costs	63	89
Straight-line rental (expense) income	(491)	419
Loss (gain) on extinguishment of debt	1,199	(194,366)
(Gain) loss on sale of investment properties, net	(12,301)	32
Provision for asset impairment	—	1,197
Non-cash stock-based compensation expense	2,249	1,438
Changes in assets and liabilities:		
Accounts and rents receivable, net	(866)	(84)
Settlement of balance due from InvenTrust	—	228
Deferred costs and other assets	(879)	(8,190)
Accounts payable and accrued expenses	(650)	9,781
Other liabilities	236	93
Net cash flows provided by operating activities	$ 10,855	$ 13,498
Cash flows from investing activities:		
Capital expenditures and tenant improvements	(2,299)	(2,295)
Investment in development	(1,678)	(2,295)
Proceeds from sale of investment properties, net	40,722	—
Acquisition of investment properties	(36,015)	(19,702)
Proceeds from insurance settlement	—	545
Payment of leasing fees	(1,255)	(284)
Net cash flows used in investing activities	$ (525)	$ (24,031)
Cash flows from financing activities:		
Payoff of mortgage debt	(19,479)	(30,273)
Prepayment penalties on the payoff of mortgage debt	(1,158)	—
Principal payments of mortgage debt	(811)	(6,029)
Payment for tax withholding for share-based compensation	(876)	(994)
Net cash flows used in financing activities	$ (22,324)	$ (37,296)
Net decrease in cash, cash equivalents and restricted cash	(11,994)	(47,829)
Cash, cash equivalents and restricted cash, at beginning of period	56,007	64,163
Cash, cash equivalents and restricted cash, at end of period	$ 44,013	$ 16,334

See accompanying notes to the condensed consolidated financial statements.

HIGHLANDS REIT, INC. AND ITS PREDECESSORS

Condensed Consolidated Statements of Cash Flow (unaudited)
(Dollar amounts in thousands)

	Nine Months Ended September 30, 2018	Nine Months Ended September 30, 2017
Supplemental disclosure of cash flow information:		
Cash paid for interest	$ 2,139	$ 5,298
Cash paid for taxes	$ 201	$ —
Supplemental schedule of non-cash investing and financing activities:		
Non-cash accruals for capital expense and investment in development	$ 1,182	$ 1,575
Mortgage loans payable and related obligations settled	$ —	$ 318,185
Real estate transferred to mortgage lender	$ —	$ (123,861)

See accompanying notes to the condensed consolidated financial statements.

Notes to Condensed Consolidated Financial Statements (unaudited)
(Amounts in thousands, except share and per share amounts)
September 30, 2018

The accompanying Condensed Consolidated Financial Statements have been prepared in accordance with U.S. generally accepted accounting principles ("GAAP") for interim financial information and with Article 10 of Regulation S-X. Accordingly, they do not include all of the information and notes required by GAAP for complete financial statements. Readers of this Quarterly Report should refer to the audited combined consolidated financial statements of Highlands REIT, Inc. for the year ended December 31, 2017, which are included in the Annual Report on Form 10-K, as filed with the U.S. Securities and Exchange Commission by Highlands REIT, Inc. on March 16, 2018, as certain note disclosures contained in such audited combined consolidated financial statements have been omitted from this Report. In the opinion of management, all adjustments (consisting of normal recurring accruals, except as otherwise noted) necessary for a fair presentation, and to make these financial statements not misleading, have been included in these financial statements.

1. Organization

Highlands REIT, Inc. ("Highlands"), which was formed in December 2015, is a Maryland corporation with a portfolio of multi-tenant office assets, industrial assets, retail assets, correctional facilities, multi-family assets, unimproved land and a bank branch. Prior to April 28, 2016, Highlands was a wholly-owned subsidiary of InvenTrust Properties Corp. ("InvenTrust" and formerly known as Inland American Real Estate Trust, Inc.).

On April 28, 2016, Highlands was spun-off from InvenTrust through a pro rata distribution by InvenTrust of 100% of the outstanding shares of common stock, $0.01 par value per share (the "Common Stock"), of Highlands to holders of record of InvenTrust's common stock as of the close of business on April 25, 2016 (the "Record Date"). Each holder of record of InvenTrust's common stock received one share of Common Stock for every one share of InvenTrust's common stock held at the close of business on the Record Date (the "Distribution"). As a result, Highlands became an independent, self-advised, non-traded public company. Highlands has elected to be taxed, and currently qualifies, as a real estate investment trust ("REIT") under the Internal Revenue Code of 1986, as amended (the "Code") for U.S. federal income tax purposes commencing with Highlands' short taxable year ending December 31, 2016. In connection with the Distribution, Highlands entered into a Separation and Distribution Agreement, Transition Services Agreement and Employee Matters Agreement with InvenTrust. Refer to Note 13 for more details.

In general, each asset in the portfolio is owned by a separate legal entity, which maintains its own books and financial records, and each entity's assets are not available to satisfy the liabilities of other affiliated entities, except as otherwise disclosed in Note 7. See also Note 2 for discussions regarding ASC 606, Revenue Recognition, and ASC 610-20, Gain or Loss From Derecognition of Non-financial Assets.

As of September 30, 2018, the Company owned 16 assets and two parcels of unimproved land. As of December 31, 2017, the Company owned 15 assets and two parcels of unimproved land.

2. Summary of Significant Accounting Policies

The accompanying condensed consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles ("GAAP") and require management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the condensed consolidated financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates.

Refer to the Company's audited combined consolidated financial statements for the year ended December 31, 2017 included in the Company's Annual Report on Form 10-K, filed with the U.S. Securities and Exchange Commission on March 16, 2018, as certain note disclosures contained in such audited financial statements have been omitted from these interim condensed consolidated financial statements.

HIGHLANDS REIT, INC. AND ITS PREDECESSORS

Notes to Condensed Consolidated Financial Statements (unaudited)
(Amounts in thousands, except share and per share amounts)
September 30, 2018

Basis of Presentation

The accompanying condensed consolidated financial statements include the accounts of Highlands and its predecessors, as well as all of Highlands' wholly-owned subsidiaries (collectively, the “Company”). Wholly-owned subsidiaries generally consist of limited liability companies (LLCs) and limited partnerships (LPs). The effects of all significant intercompany transactions have been eliminated.

Revenue Recognition

The Company commences revenue recognition on our leases based on a number of factors. In most cases, revenue recognition under a lease begins when the lessee takes possession of or controls the physical use of the leased asset. Generally, this occurs on the lease commencement date. The determination of who is the owner, for accounting purposes, of the tenant improvements determines the nature of the leased asset and when revenue recognition under a lease begins. If we are the owner, for accounting purposes, of the tenant improvements, then the leased asset is the finished space and revenue recognition begins when the lessee takes possession of the finished space, typically when the improvements are substantially complete. If we conclude we are not the owner, for accounting purposes, of the tenant improvements (the lessee is the owner), then the leased asset is the unimproved space and any tenant improvement allowances funded under the lease are treated as lease incentives which reduces revenue recognized over the term of the lease. In these circumstances, we begin revenue recognition when the lessee takes possession of the unimproved space for the lessee to construct their own improvements. We consider a number of different factors to evaluate whether the Company or the lessee is the owner of the tenant improvements for accounting purposes. These factors include:

- whether the lease stipulates how and on what a tenant improvement allowance may be spent;
- whether the tenant or landlord retains legal title to the improvements;
- the uniqueness of the improvements;
- the expected economic life of the tenant improvements relative to the length of the lease; and
- who constructs or directs the construction of the improvements.

The determination of who owns the tenant improvements, for accounting purposes, is subject to significant judgment. In making that determination, we consider all of the above factors. No one factor, however, necessarily establishes its determination.

Rental income is recognized on a straight-line basis over the term of each lease. The difference between rental income earned on a straight-line basis and the cash rent due under the provisions of the lease agreements is recorded as deferred rent receivable and is included as a component of accounts and rents receivable in the accompanying condensed consolidated balance sheets.

The Company records lease termination income if there is a signed termination agreement, all of the conditions of the agreement have been met and amounts due are considered collectible.

Share-based Compensation

In accordance with FASB ASC Topic 718, Compensation - Stock Compensation, companies are required to recognize in the income statement the grant-date fair value of stock options and other equity based compensation issued to employees. Under Topic 718, the way an award is classified will affect the measurement of compensation cost. Equity classified awards are measured at grant date fair value, and amortized on a straight-line basis over the vesting period of the stock and are not subsequently re-measured. The cost of the share based payments that are fully vested at the grant date are measured and recognized at that date.

Earnings Per Share

Basic earnings per share ("EPS") is computed by dividing the net income (loss) attributable to common stockholders by the weighted-average number of common shares outstanding for the period. Diluted EPS is calculated by dividing net income (loss) attributable to common stockholders by the weighted average number of common shares outstanding during the period plus any additional common shares that would have been outstanding if the dilutive potential common shares had been issued. Any anti-dilutive securities are excluded from the diluted earnings per-share calculation.

Recently Issued Accounting Pronouncements

In February 2016, the FASB issued ASU No. 2016-02, Leases ("ASU 2016-02"), which introduces a lessee model that brings most leases on the balance sheet and, among other changes, eliminates the requirement in current GAAP for an entity to use bright-line tests in determining lease classification. In March 2018, the FASB approved an amendment to ASU 2016-02, which would provide lessors with a practical expedient, by class of underlying assets, to not separate non-lease components from the related lease components and, instead, to account for those components as a single lease component, if certain criteria are met. In July 2018, the FASB issued ASU No. 2018-10, Codification Improvements to Topic 842 (Leases), which provides narrow amendments to clarify how to apply certain aspects of the new lease standard. Also in July 2018, the FASB issued ASU No. 2018-11, Leases (Topic 842): Targeted Improvements. This ASU allows entities to not recast comparative periods in transition to ASC 842 and instead report the comparative periods presented in the period of adoption under ASC 840. The ASU also includes a practical expedient for lessors to not separate the lease and nonlease components of a contract. The amendments in this ASU are effective in the same timeframe as ASU No. 2016-02 as discussed above. We are incorporating this ASU into our assessment and adoption of ASU No. 2016-02. ASC 842 (Leases) is not effective for the Company until January 1, 2019, with early adoption permitted. We are continuing to evaluate this guidance and the impact to us, as both lessor and lessee, on our condensed consolidated financial statements. We expect to utilize the practical expedients proposed in the amended ASC 842 as part of our adoption.

In June 2018, the FASB issued ASU No. 2018-07, Compensation – Stock Compensation (Topic 718), Improvements to Nonemployee Share-Based Payment Accounting. This ASU is intended to simplify aspects of share-based compensation issued to non-employees by making the guidance consistent with the accounting for employee share-based compensation. It is effective for annual reporting periods, and interim periods within those years, beginning after December 15, 2018. The adoption of ASU No. 2018-07 is not expected to have a material impact on the condensed consolidated financial statements.

In August 2018, the FASB issued ASU No. 2018-13, Fair Value Measurement (Topic 820): Disclosure Framework – Changes to the Disclosure Requirements for Fair Value Measurement. This ASU modifies the disclosure requirements on fair value measurements. The ASU removes the requirement to disclose: the amount of and reasons for transfers between Level 1 and Level 2 of the fair value hierarchy; the policy for timing of transfers between levels; and the valuation processes for Level 3 fair value measurements. Our effective date for adoption of this guidance is our fiscal year beginning January 1, 2020 with early adoption permitted. We are currently evaluating the effect that this guidance will have on our condensed consolidated financial statements.

Recently Adopted Accounting Pronouncements

In May 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers. The core objective of ASU No. 2014-09 (as codified in ASC 606) is for an entity to recognize revenue based on the consideration it expects to receive in exchange for goods or services. Additionally, this ASU requires entities to use a single model in accounting for revenues derived from contracts with customers. ASU No. 2014-09 replaces prior guidance regarding the recognition of revenue from sales of real estate, except for revenue from sales that are part of a sale-leaseback transaction. The provisions of ASU No. 2014-09, as subsequently amended in conjunction with ASU No. 2016-08, Principal versus Agent Considerations (Reporting Revenue Gross Versus Net), comprise ASC 606, Revenue Recognition, became effective for us on January 1, 2018. The Company elected the modified retrospective method of adoption, but determined that there was no cumulative adjustment to be recorded in connection with the adoption of ASC 606. We have evaluated all of our revenue streams to identify which of our revenue streams would be subject to the provisions of ASC 606 and any differences in the timing, measurement or presentation of revenue recognition. In evaluating our revenue streams, substantially all of our revenues result from leasing transactions that are not within the scope of the new standard and will be governed by the recently issued leasing guidance, ASU No. 2016-02, which is discussed above and will not be effective until January 1, 2019. As a result, the Company has concluded that the adoption of ASC 606 did not have a material impact on the process for, timing of, and presentation and disclosure of revenue recognition from contracts with tenants and other customers.

(Amounts in thousands, except share and per share amounts)

In August 2016, the FASB issued ASU No. 2016-15, Classification of Certain Cash Receipts and Cash Payments. ASU No. 2016-15 addresses eight specific cash flow issues with the objective of reducing diversity in practice. The cash flow issues include debt prepayment or debt extinguishment costs and proceeds from the settlement of insurance claims. The Company adopted ASU No. 2016-15 effective January 1, 2018, the effects of which were not material to the condensed consolidated financial statements.

In November 2016, the FASB issued ASU No. 2016-18, Classification and Presentation of Restricted Cash in the Statement of Cash Flows. ASU No. 2016-18 requires an explanation in the cash flow statement of a change in the total of (1) total cash, (2) cash equivalents, and (3) restricted cash or restricted cash equivalents. The Company adopted ASU No. 2016-18 effective January 1, 2018, the effects of which include presenting restricted cash and escrows with cash and cash equivalents in the condensed consolidated statement of cash flow. The Company is required to escrow cash balances for specific uses stipulated by certain of its lenders and other various agreements. As of September 30, 2018 and December 31, 2017, the Company's cash balances restricted for these uses were $2,020and $2,155, respectively. The inclusion of restricted cash increased cash, cash equivalents and restricted cash, at the beginning of the period, in the unaudited condensed consolidated statement of cash flow by $2,155 and $7,034 as of January 1, 2018 and 2017, respectively, and cash, cash equivalents and restricted cash, at end of period, by $2,020 and $1,645, as of September 30, 2018 and 2017, respectively.

The table below provides a reconciliation of cash, cash equivalents, and restricted cash reported within the condensed consolidated balance sheets that sum to the total of the same such amounts shown on the condensed consolidated statements of cash flow.

	September 30, 2018	December 31, 2017
Cash and cash equivalents	$ 41,993	$ 53,852
Restricted cash	2,020	2,155
Total cash, cash equivalents and restricted cash	$ 44,013	$ 56,007

In January 2017, the FASB issued ASU No. 2017-01, Business Combinations (ASC 805) Clarifying the Definition of a Business (ASU 2017-01). ASU 2017-1 clarifies the definition of a business with the objective of adding guidance to assist entities with evaluating whether transactions should be accounted for as acquisitions (or disposals) of assets or businesses. The definition of a business affects many areas of accounting, including acquisitions (including treatment of acquisition costs), disposals, goodwill, and consolidation. The guidance is effective for annual periods beginning after December 15, 2018, including interim periods within those periods. Early adoption of this standard is permitted. The Company early adopted ASU 2017-01 effective as of July 1, 2017, the effects of which were not material to the condensed consolidated financial statements.

In February 2017, the FASB issued ASU No. 2017-05, Other Income—Gains and Losses from the Derecognition of Nonfinancial Assets. As it relates to gains on sale of real estate, we will apply the provisions of ASC 610-20, Gain or Loss From Derecognition of Non-financial Assets (ASC 610-20), and we expect to recognize any gains when we transfer control of a property and when it is probable that we will collect substantially all of the related consideration. The adoption of ASC 610-20 on January 1, 2018 did not have a material impact on our condensed consolidated financial statements.

In May 2017, the FASB issued ASU No. 2017-09, Compensation-Stock Compensation (Topic 718), Scope of Modification Accounting. ASU No. 2017-09 clarifies when changes to the terms or conditions of a share-based payment award must be accounted for as modifications. The guidance is effective prospectively for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years, and early adoption is permitted. The early adoption of ASU No. 2017-09 in 2017 did not have a material impact on the condensed consolidated financial statements.

(Amounts in thousands, except share and per share amounts)

3. Acquired Properties

The Company records identifiable assets and liabilities acquired at fair value. During the nine months ended September 30, 2018, the Company acquired three multi-tenant residential assets for a gross acquisition price of $35,775. Under ASU No. 2017-01, the Company determined these transactions should be accounted for as asset acquisitions. Accordingly, the Company capitalized transaction costs of approximately $240.

The following table reflects the properties acquired during the nine months ended September 30, 2018.

Property	Location	Acquisition Date	Gross Acquisition Price	
The Lafayette	Denver, CO	May 15, 2018	$	9,525
1620 Central Street	Evanston, IL	August 22, 2018		20,500
Kenilworth Court	Denver, CO	September 12, 2018		5,750
			$	35,775

During the three and nine months ended September 30, 2017, the Company acquired two buildings for a gross acquisition price of $19,602. Although acquired in a single transaction on August 21, 2017, the special purpose entity that now owns these assets contains the operations of the two distinct multi-family assets, Buerger Brothers Lofts and Chamber Lofts which are managed independently, and have been determined by management to be accounted for as two distinct assets. Under ASU No. 2017-01, the Company determined this transaction should be accounted for as an asset acquisition. Accordingly, the Company capitalized transaction costs of approximately $100 during the three and nine months ended September 30, 2017.

4. Disposed Properties

The following table reflects the property dispositions during the nine months ended September 30, 2018. The Company recognized a net gain on sale of investment properties of $12,301.

Property	Location	Disposition Date	Gross Disposition Price	
Buckhorn Plaza (partial lot sale)	Bloomsburg, PA	February 8, 2018	$	60
Rolling Plains (correctional facility)	Haskell, TX	August 7, 2018		3,600
Triangle Center (1)	Longview, WA	September 24, 2018		38,340
			$	42,000

(1) Mortgage debt in the amount of $19,479 was paid off with the proceeds from the sale.

The following properties were transferred to their respective lenders during 2017 as part of cooperative foreclosure processes.

On April 10, 2017, the Company conveyed its Dulles Executive Plaza asset to its lenders via a deed of assumption and the non-recourse Commercial Mortgage-Backed Security (“CMBS”) debt was fully extinguished. Upon conveyance of the property, the Company was fully released from its nonrecourse indebtedness, had no further continuing obligations to the lender, and conveyed the usual risks and rewards of ownership. The Company recognized a gain on extinguishment of debt relating to this transaction in the amount of $4,271 for the nine months ended September 30, 2017.

On April 20, 2017, the AT&T-Hoffman Estates asset was sold via sheriff's sale as part of the foreclosure process, which was approved by the court on May 18, 2017. The court appointed receiver was discharged on July 6, 2017. As a result of the foreclosure sale, the Company satisfied its nonrecourse indebtedness, had no further continuing obligations to the lender, and conveyed the usual risks and rewards of ownership. The Company recognized a gain on extinguishment of debt relating to this transaction in the amount of $112,629 for the nine months ended September 30, 2017.

(Amounts in thousands, except share and per share amounts)

On August 22, 2017, the AT&T-St. Louis asset was sold via sheriff's sale as part of the foreclosure process. As a result of the foreclosure sale, the Company satisfied its nonrecourse indebtedness and had no further continuing obligations to the lender. The Company recognized a gain on extinguishment of debt relating to this transaction in the amount of $77,466 for the nine months ended September 30, 2017.

There were no assets that qualified as discontinued operations during the nine months ended September 30, 2018 and 2017.

5. Pro Forma Financial Information

The table set forth below summarizes, on a pro forma basis, the condensed consolidated results of operations of the Company for the three and nine months ended September 30, 2018 and 2017. Such presentation reflects the Company's disposition of Triangle Center (the "Property"), which was completed on September 24, 2018. The pro forma condensed consolidated results of operations reflect the disposition of the Property as if the transaction occurred on January 1, 2017.

This pro forma information does not purport to represent what the actual condensed consolidated results of operations of the Company would have been for the periods indicated, nor does it purport to predict the results of operations for future periods.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
Pro forma revenue	$ 10,624	$ 11,964	$ 29,954	$ 41,709
Pro forma net income from continuing operations and attributable to the registrant	$ 4,514	$ 80,513	$ 4,439	$ 188,746
Pro forma net income from continuing operations and attributable to the registrant per common share, basic and diluted	$ 0.01	$ 0.09	$ 0.01	$ 0.22

6. Accounts Payable and Accrued Expenses

Accounts payable and accrued expenses consist of the following:

	September 30, 2018	December 31, 2017
Accrued real estate taxes	$ 5,589	$ 6,488
Accrued compensation	2,304	1,919
Accrued interest payable	117	206
Other accrued expenses	2,654	2,435
Total accounts payable and accrued expenses	$ 10,664	$ 11,048

7. Mortgage Loans, Net

Mortgage loans outstanding as of September 30, 2018 and December 31, 2017, net of unamortized deferred financing costs, were $35,088 and $55,273, respectively, and had a weighted average interest rate of 4.74% per annum. Deferred financing costs, net, as of September 30, 2018 and December 31, 2017 were $508 and $613, respectively. As of September 30, 2018, scheduled maturities for the Company's outstanding mortgage indebtedness had various due dates through December 2026, as follows:

(Amounts in thousands, except share and per share amounts)

For the year ended December 31,	As of September 30, 2018	Weighted average interest rate
2019	$ —	—%
2020	—	—%
2021	—	—%
2022	9,413	5.24%
Thereafter	26,183	4.56%
Total	$ 35,596	4.74%

The Company's ability to pay off mortgages when they become due is dependent upon the Company's ability either to refinance the related mortgage debt or to sell the related asset. With respect to each loan, if the applicable wholly-owned property-owning subsidiary is unable to refinance or sell the related asset, or in the event that the estimated asset value is less than the mortgage balance, the applicable wholly-owned property-owning subsidiary may, if appropriate, satisfy a mortgage obligation by transferring title of the asset to the lender or permitting a lender to foreclose. As of September 30, 2018 and December 31, 2017, no debt is recourse to the Company, although Highlands or its subsidiaries may act as guarantor under customary, non-recourse carve-out clauses in our wholly-owned property-owning subsidiaries' mortgage loans.

Some of the mortgage loans require compliance with certain covenants, such as debt service ratios, investment restrictions and distribution limitations. As of September 30, 2018 and December 31, 2017, the Company is in compliance with such covenants in all material respects.

8. Fair Value Measurements

In accordance with ASC 820, Fair Value Measurement and Disclosures, the Company defines fair value based on the price that would be received upon sale of an asset or the exit price that would be paid to transfer a liability in an orderly transaction between market participants at the measurement date. The Company uses a fair value hierarchy that prioritizes observable and unobservable inputs used to measure fair value. The fair value hierarchy consists of three broad levels, which are described below:

- Level 1 - Quoted prices in active markets for identical assets or liabilities that the entity has the ability to access.
- Level 2 - Observable inputs, other than quoted prices included in Level 1, such as quoted prices for similar assets and liabilities in active markets; quoted prices for identical or similar assets and liabilities in markets that are not active; or other inputs that are observable or can be corroborated by observable market data.
- Level 3 - Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets and liabilities. This includes certain pricing models, discounted cash flow methodologies and similar techniques that use significant unobservable inputs.

The Company has estimated fair value using available market information and valuation methodologies the Company believes to be appropriate for these purposes. Considerable judgment and a high degree of subjectivity are involved in developing these estimates and, accordingly, they are not necessarily indicative of amounts that would be realized upon disposition.

Non-Recurring Measurements

During the nine months ended September 30, 2018, the Company did not identify any impairment triggers that required the assets to be measured at fair value.

During the nine months ended September 30, 2017, the Company identified certain assets which may have a reduction in the expected holding period, which represented an impairment trigger, and recorded an impairment of investment properties of $1,197 on one of the land parcels and one of the multi-tenant office assets. The following table presents these assets measured at fair value on a nonrecurring basis as of September 30, 2017 aggregated by the level within the fair value hierarchy in which those measurements fall. Methods and assumptions used to estimate the fair value of these assets are described after the table.

(Amounts in thousands, except share and per share amounts)

	Fair Value				Provision for impairment
	Level 1	Level 2	Level 3	Total	
Investment properties	$ —	$ —	$ 8,750 (a)	$ 8,750	$ 1,197

(a) The estimate of fair value of the land parcel and retail asset was based on recent negotiations for the sale of these assets to third parties.

Financial Instruments Not Measured at Fair Value

The table below represents the fair value of financial instruments presented at carrying values in the condensed consolidated financial statements as of September 30, 2018 and as of December 31, 2017.

	September 30, 2018		December 31, 2017	
	Carrying Value	Estimated Fair Value	Carrying Value	Estimated Fair Value
Mortgages payable	$ 35,596	$ 34,719	$ 55,886	$ 56,862

The Company typically estimates the fair value of its debt instruments using a weighted average market effective interest rate of 5.04% per annum as of September 30, 2018. The Company estimates the fair value of its mortgages payable by discounting the anticipated future cash flows of each instrument at rates currently offered to the Company by its lenders for similar debt instruments of comparable maturities. The rates used are based on credit spreads observed in the marketplace during the quarter for similar debt instruments, and a floor rate that the Company has derived using its subjective judgment for each asset segment. Based on this, the Company determines the appropriate rate for each of its individual mortgages payable based upon the specific terms of the agreement, including the term to maturity, the quality and nature of the underlying property and its leverage ratio. The weighted average market effective interest rates used range from 4.53% to 5.38% as of September 30, 2018. For certain debt, the Company estimates the fair value of debt instruments based on the fair value of the underlying collateral. The Company has determined that its debt instrument valuations are classified in Level 2 of the fair value hierarchy.

9. Income Taxes

The Company is taxed and operates in a manner that will allow the Company to continue to qualify as a REIT for U.S. federal income tax purposes. So long as it maintains its qualification as a REIT, the Company generally will not be subject to U.S. federal income tax on taxable income that is distributed to stockholders. A REIT is subject to a number of organizational and operational requirements, including a requirement that it distribute at least 90% of its REIT taxable income (subject to certain adjustments) to its stockholders each year. If the Company fails to continue to qualify as a REIT in any taxable year, without the benefit of certain relief provisions, the Company will be subject to U.S. federal and state income tax on its taxable income at regular corporate tax rates and would not be able to re-elect REIT status during the four years following the year of the failure. Although the Company qualifies for taxation as a REIT, the Company may be subject to certain state and local taxes on its income and U.S. federal income and excise taxes on its undistributed income.

During the three and nine months ended September 30, 2018, an income tax benefit of $0 and $155, respectively, was included on the condensed consolidated statements of operations. During the three and nine months ended September 30, 2017, an income tax benefit of $0 and $7, respectively, was included on the condensed consolidated statements of operations.

10. Segment Reporting

HIGHLANDS REIT, INC. AND ITS PREDECESSORS

Notes to Condensed Consolidated Financial Statements (unaudited)
(Amounts in thousands, except share and per share amounts)
September 30, 2018

GAAP has established guidance for reporting information about a company’s operating segments. The Company monitors and reviews its segment reporting structure in accordance guidance under Financial Accounting Standards Board (“FASB”) Accounting Standards Codification (“ASC”) Topic 280, Segment Reporting (“ASC 280”) to determine whether any changes have occurred that would impact its reportable segments. In the three months ended September 30, 2018, as a result of the evolution of the Company’s operations and asset acquisitions, the Company has determined it no longer operates in three operating segments. The Company has concluded its multi-family assets now represent one operating segment. As a result of this change in the Company’s segment reporting, the Company currently has four business segments, consisting of (i) net lease, (ii) retail, (iii) multi-tenant office and (iv) multi-family. The net lease segment consists of single-tenant office and industrial assets, as well as the Company’s correctional facilities. The Company’s unimproved land assets are presented below in Other. The following table summarizes net property operations income by segment for the three months ended September 30, 2018.

	Total	Net Lease	Retail	Multi-Tenant Office	Multi-family	Other
Rental income	$ 9,323	$ 3,120	$ 4,146	$ 1,450	$ 607	$ —
Tenant recovery income	2,123	62	2,036	(4)	29	—
Other property income	203	—	13	92	98	—
Total income	11,649	3,182	6,195	1,538	734	—
Operating expenses and real estate taxes	3,741	98	2,524	685	284	150
Net operating income	$ 7,908	$ 3,084	$ 3,671	$ 853	$ 450	$ (150)
Non-allocated expenses (a)	(6,000)					
Other income and expenses (b)	(596)					
Gain on sale of investment properties (c)	12,276					
Loss on extinguishment of debt	$ (1,199)					
Net income	$ 12,389					

(a) Non-allocated expenses consist of general and administrative expenses and depreciation and amortization.

(b) Other income and expenses consists of interest income, other income and interest expense.

(c) Gain on the sale of investment properties is related to one retail asset and one other asset.

(d) Loss on extinguishment of debt is related to prepayment penalties on the payoff of mortgage debt.

(Amounts in thousands, except share and per share amounts)

The following table summarizes net property operations income by segment for the three months ended September 30, 2017.

	Total	Net Lease	Retail	Multi-Tenant Office	Multi-family	Other
Rental income	$ 10,901	$ 5,344	$ 4,086	$ 1,339	$ 132	$ —
Tenant recovery income	1,973	40	1,927	1	5	—
Other property income	129	—	13	87	23	6
Total income	13,003	5,384	6,026	1,427	160	6
Operating expenses	3,747	192	2,359	795	72	329
Net operating income (loss)	$ 9,256	$ 5,192	$ 3,667	$ 632	$ 88	$ (323)
Non-allocated expenses (a)	(5,377)					
Other income and expenses (b)	(35)					
Provision for asset impairment (c)	(485)					
Loss on sale of investment properties	(29)					
Gain on extinguishment of debt (d)	77,466					
Net income	$ 80,796					

(a) Non-allocated expenses consist of general and administrative expenses and depreciation and amortization.

(b) Other income and expenses consist of other income, interest income, interest expense and income tax expense.

(c) Provision for asset impairment is for one multi-tenant office asset.

(d) Gain on extinguishment of debt is related to one net lease asset. Refer to Note 4 for additional information.

(Amounts in thousands, except share and per share amounts)

The following table summarizes net property operations income by segment for the nine months ended September 30, 2018.

	Total	Net Lease	Retail	Multi-Tenant Office	Multi-family	Other
Rental income	$ 26,401	$ 9,359	$ 12,578	$ 3,231	$ 1,233	$ —
Tenant recovery income	5,991	183	5,677	61	70	—
Other property income	725	—	32	432	261	—
Total income	33,117	9,542	18,287	3,724	1,564	—
Operating expenses and real estate taxes	10,276	458	7,201	2,064	667	(114)
Net operating income	$ 22,841	$ 9,084	$ 11,086	$ 1,660	$ 897	$ 114
Non-allocated expenses (a)	(19,529)					
Other income and expenses (b)	(1,565)					
Gain on sale of investment properties (c)	12,301					
Loss on extinguishment of debt (d)	(1,199)					
Net income	$ 12,849					
Balance Sheet Data						
Real estate assets, net (e)	$ 268,991	$ 40,730	$ 116,462	$ 47,470	$ 54,651	$ 9,678
Non-segmented assets (f)	53,793					
Total assets	$ 322,784					
Capital expenditures	$ 3,977	$ —	$ 1,835	$ 2,076	$ 9	$ 57

(a) Non-allocated expenses consists of general and administrative expenses and depreciation and amortization.

(b) Other income and expenses consists of interest income, other income, interest expense and income tax benefit.

(c) Gain on the sale of investment properties is related to one retail asset, a parcel of one retail asset and one other asset.

(d) Loss on extinguishment of debt is related to prepayment penalties on the payoff of mortgage debt.

(e) Real estate assets include intangible assets, net of amortization.

(f) Non-segmented assets include cash and cash equivalents, restricted cash and escrows, accounts and rents receivable and deferred costs and other assets.

(Amounts in thousands, except share and per share amounts)

The following table summarizes net property operations income by segment for the nine months ended September 30, 2017.

	Total	Net Lease	Retail	Multi-Tenant Office	Multi-family	Other
Rental income	$ 38,260	$ 20,088	$ 12,259	$ 5,782	$ 132	$ (1)
Tenant recovery income	5,640	233	5,413	(55)	5	44
Other property income	823	60	420	296	23	24
Total income	44,723	20,381	18,092	6,023	160	67
Operating expenses and real estate taxes	14,291	3,431	6,744	2,984	72	1,060
Net operating income (loss)	$ 30,432	$ 16,950	$ 11,348	$ 3,039	$ 88	$ (993)
Non-allocated expenses (a)	(22,551)					
Other income and expenses (b)	(11,656)					
Provision for asset impairment (c)	(1,197)					
Loss on sale of investment properties	(32)					
Gain on extinguishment of debt (d)	194,366					
Net income	$ 189,362					
Balance Sheet Data						
Real estate assets, net (e)	$ 321,091	$ 68,057	$ 149,407	$ 52,740	$ 19,596	$ 31,591
Non-segmented assets (f)	24,454					
Total assets	$ 345,545					
Capital expenditures	$ 6,165	$ —	$ 668	$ 5,344	$ —	$ 153

(a) Non-allocated expenses consists of general and administrative expenses and depreciation and amortization.

(b) Other income and expenses consists of other income, interest income, interest expense and income tax expense.

(c) Provision for asset impairment is for one other related asset and one multi-tenant office asset.

(d) Gain on extinguishment of debt is related to two net lease and one multi-tenant office related assets. Refer to Note 4 for additional information.

(e) Real estate assets include intangible assets, net of amortization.

(f) Non-segmented assets include cash and cash equivalents, restricted cash and escrows, accounts and rents receivable and deferred costs and other assets.

11. Earnings Per Share

Basic earnings per common share is calculated by dividing net income (loss) by the weighted-average number of common shares outstanding during the period. Diluted earnings per common share is calculated by dividing net income (loss) by the weighted-average number of common shares outstanding during the period, plus any additional common shares that would have been outstanding if the dilutive potential common shares had been issued.

The following table reconciles net income attributable to the Company to basic and diluted EPS (in thousands, except share and per share data):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
Numerator:				
Net income	$ 12,389	$ 80,796	$ 12,849	$ 189,362
Denominator:				
Weighted average shares outstanding - basic and diluted	871,537,188	868,423,581	871,027,452	867,439,543
Basic and diluted income per share:				
Net income per common share	$ 0.01	$ 0.09	$ 0.01	$ 0.22

12. Share Based Compensation

Incentive Award Plan

On April 28, 2016, the board of directors adopted, ratified and approved the Highlands REIT, Inc. 2016 Incentive Award Plan (the “Incentive Award Plan”), under which the Company may grant cash and equity-based incentive awards to eligible employees, directors, and consultants. Prior to the Company’s spin-off from InvenTrust, the board of directors of the Company (then a wholly-owned subsidiary of InvenTrust) adopted, and InvenTrust, as the sole stockholder of Highlands, approved, the Incentive Awards Plan.

As of September 30, 2018, the Company has granted 5,772,728 of fully vested shares of common stock with an aggregate value of $1,905 based on an estimated net asset value per share of $0.33. Additionally, pursuant to an employment agreement with one of its executive officers, the Company has granted shares with an aggregate value of $700 that will fully vest on March 15, 2019, subject to the applicable executive's continued employment with the Company through the vest date.

Under the guidance of ASC 718, during the nine months ended September 30, 2017, 1,940,476 shares of common stock awards were treated as a modification of the terms of the original awards for two of the Company’s executive officers, resulting in an increase in compensation expense of $650 at the modification date.

Under the Incentive Award Plan, the Company is authorized to grant up to 43,000,000 shares of the Company's common stock pursuant to awards under the plan. At September 30, 2018, 23,595,743 shares were available for future issuance under the Incentive Award Plan. A summary of the Company's stock awards activity as of September 30, 2018 is as follows:

(Amounts in thousands, except share and per share amounts)

Non-Vested stock awards	Stock Awards	Weighted Average Grant Date Fair Value
Outstanding at January 1, 2018	—	$ —
Granted	7,893,940	0.33
Vested	(5,772,728)	0.33
Forfeited	—	—
Balance at September 30, 2018	2,121,212	$ 0.33

For the three and nine months ended September 30, 2018, the Company recognized stock-based compensation expense of $196 and $2,249, respectively, related to the Incentive Award Plan. At September 30, 2018, there was approximately $356 of estimated unrecognized compensation expense related to these awards, which is expected to be recognized through March 15, 2019. For the three and nine months ended September 30, 2017, the Company recognized stock-based compensation expense of $0 and $1,438, respectively. For the three and nine months ended September 30, 2018, the Company paid $0 and $876, respectively, and for the three and nine months ended September 30, 2017, the Company paid $0 and $994, respectively, related to tax withholding for share-based compensation.

The Company repurchased and retired 116,334 of fully vested shares previously awarded to an employee pursuant to a separation agreement during the nine months ended September 30, 2018. The shares were repurchased for $0.33 per share, which was based on the Company's most recently announced estimated share value.

13. Commitments and Contingencies

The Company is subject, from time to time, to various legal proceedings and claims that arise in the ordinary course of business. While the resolution of these matters cannot be predicted with certainty, management believes, based on currently available information, that the final outcome of such matters will not have a material adverse effect on the financial statements of the Company.

In addition, in connection with the Company’s separation from InvenTrust, on April 14, 2016, the Company entered into a Separation and Distribution Agreement, and on April 28, 2016, the Company entered into a Transition Services Agreement and Employee Matters Agreement, each with InvenTrust. Pursuant to the Separation and Distribution Agreement, Highlands has agreed to indemnify, defend and hold harmless InvenTrust and its affiliates and each of their respective current or former stockholders, directors, officers, agents and employees and their respective heirs, executors, administrators, successors and assigns from and against all liabilities relating to, arising out of or resulting from (i) the liabilities assumed by Highlands in the Separation and Distribution Agreement, Transition Services Agreement and Employee Matters Agreement, (ii) any breach by Highlands or any of its subsidiaries of the Separation and Distribution Agreement, Transition Services Agreement and Employee Matters Agreement (iii) losses arising from third party claims relating to the separation and distribution and (iv) any untrue statement or alleged untrue statement of a material fact or omission or alleged omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, with respect to all information contained in the Registration Statement, other than specified information relating to and provided by InvenTrust (the “Specified InvenTrust Information”). Similarly, InvenTrust has agreed to indemnify, defend and hold harmless Highlands and its affiliates and each of their respective current or former stockholders, directors, officers, agents and employees and their respective heirs, executors, administrators, successors and assigns from and against all liabilities relating to, arising out of or resulting from (i) the liabilities assumed by InvenTrust in the Separation and Distribution Agreement, Transition Services Agreement and Employee Matters Agreement, (ii) any breach by InvenTrust or any of its subsidiaries of the Separation and Distribution Agreement, Transition Services Agreement and Employee Matters Agreement and (iii) the Specified InvenTrust Information. InvenTrust and Highlands will not be deemed to be affiliates of the other for purposes of determining the above described indemnification obligations.

Highlands has also agreed to indemnify InvenTrust against all taxes related to the Company, its subsidiaries and its assets, including taxes attributable to periods prior to the separation and distribution. InvenTrust has agreed to indemnify the Company for any taxes attributable to a failure by InvenTrust or MB REIT (Florida), Inc., a subsidiary of the Company, to qualify as a REIT for any taxable year ending on or before December 31, 2016.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with "Part I-Financial Information," and the historical combined consolidated financial statements, and related notes included elsewhere in our Annual Report on Form 10-K. The following discussion and analysis contains forward-looking statements based upon our current expectations, estimates and assumptions that involve risks and uncertainties. Our actual results could differ materially from those discussed in these forward-looking statements due to a variety of risks, uncertainties and other factors, including but not limited to, factors discussed in "Part I-Item 1A. Risk Factors" and "Disclosure Regarding Forward-Looking Statements in our Annual Report on Form 10-K." The following discussion and analysis should be read in conjunction with the Company's Combined Consolidated Financial Statements and accompanying notes, which appear in our Annual Report on Form 10-K.

Certain statements in this Quarterly Report on Form 10-Q, other than purely historical information, are "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995, Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). These statements include statements about Highlands' plans, objectives, strategies, financial performance and outlook, trends, the amount and timing of future cash distributions, prospects or future events and involve known and unknown risks that are difficult to predict. As a result, our actual financial results, performance, achievements or prospects may differ materially from those expressed or implied by these forward-looking statements. In some cases, you can identify forward-looking statements by the use of words such as "may," "could," "expect," "intend," "plan," "seek," "anticipate," "believe," "estimate," "guidance," "predict," "potential," "continue," "likely," "will," "would," "illustrative" and variations of these terms and similar expressions, or the negative of these terms or similar expressions. Such forward-looking statements are necessarily based upon estimates and assumptions that, while considered reasonable by Highlands and its management based on their knowledge and understanding of the business and industry, are inherently uncertain. These statements are not guarantees of future performance, and stockholders should not place undue reliance on forward-looking statements. There are a number of risks, uncertainties and other important factors, many of which are beyond our control, that could cause our actual results to differ materially from the forward-looking statements contained in this Quarterly Report on Form 10-Q. Such risks, uncertainties and other important factors include, among others: the risks, uncertainties and factors set forth in our filings with the U.S. Securities and Exchange Commission, including our Annual Report on Form 10-K; business, financial and operating risks inherent to real estate investments and the industry; our ability to renew leases, lease vacant space, or re-let space as leases expire; our ability to repay or refinance our debt as it comes due; difficulty selling or re-leasing our properties due to their specific characteristics as described elsewhere in this report; the business, financial and operating risks inherent to real estate investments; contraction in the global economy or low levels of economic growth; our ability to sell our assets at a price and on a timeline consistent with our investment objectives, or at all; our ability to service our debt; changes in interest rates and operating costs; compliance with regulatory regimes and local laws; uninsured or underinsured losses, including those relating to natural disasters or terrorism; our status as an emerging growth company; the amount of debt that we currently have or may incur in the future; provisions in our debt agreements that may restrict the operation of our business; our separation from InvenTrust and our ability to operate as a stand-alone public reporting company; our organizational and governance structure; our status as a REIT; the cost of compliance with and liabilities under environmental, health and safety laws; adverse litigation judgments or settlements; changes in real estate and zoning laws and increase in real property tax rates; changes in federal, state or local tax law, including legislative, administrative, regulatory or other actions affecting REITs; changes in governmental regulations or interpretations thereof; and estimates relating to our ability to make distributions to our stockholders in the future.

These factors are not necessarily all of the important factors that could cause our actual financial results, performance, achievements or prospects to differ materially from those expressed in or implied by any of our forward-looking statements. Other unknown or unpredictable factors also could harm our results. All forward-looking statements attributable to us or persons acting on our behalf are expressly qualified in their entirety by the cautionary statements set forth above. Forward-looking statements speak only as of the date they are made, and we do not undertake or assume any obligation to update publicly any of these forward-looking statements to reflect actual results, new information or future events, changes in assumptions or changes in other factors affecting forward-looking statements, except to the extent required by applicable laws. If we update one or more forward-looking statements, no inference should be drawn that we will make additional updates with respect to those or other forward-looking statements.

The following discussion and analysis should be read in conjunction with the Company's Condensed Consolidated Financial Statements and accompanying notes, which appear elsewhere in this Quarterly Report on Form 10-Q.

Overview

We are a self-advised and self-administered real estate investment trust ("REIT") originally created to own and manage substantially all of the "non-core" assets previously owned and managed by our former parent, InvenTrust Properties Corp., a Maryland corporation ("InvenTrust"). On April 28, 2016, we were spun-off from InvenTrust through a pro rata distribution (the "Distribution") by InvenTrust of 100% of the outstanding shares of our common stock to holders of InvenTrust's common stock. Prior to or concurrent with the separation, we and InvenTrust engaged in certain reorganization transactions that were designed to consolidate substantially all of InvenTrust's remaining "non-core" assets in Highlands REIT.

This portfolio of "non-core" assets, which were acquired by InvenTrust between 2005 and 2008, included assets that are special use, single tenant or build to suit; face unresolved legal issues; are in undesirable locations or in weak markets or submarkets; are aging or functionally obsolete; and/or have sub-optimal leasing metrics. A number of our assets are retail properties located in tertiary markets, which are particularly susceptible to the negative trends affecting retail real estate. As a result of these characteristics, such assets are difficult to lease, finance and refinance and are relatively illiquid compared to other types of real estate assets. These factors also significantly limit our asset disposition options, impact the timing of such dispositions and restrict the viable options available to the Company for a future potential liquidity event.

Our strategy is focused on preserving, protecting and maximizing the total value of our portfolio with the long-term objective of providing stockholders with a return of their investment. We engage in rigorous asset management, and seek to sustain and enhance our portfolio, and improve the quality and income-producing ability of our portfolio, by engaging in selective dispositions, acquisitions, capital expenditures, financing, refinancing and enhanced leasing. We are also focused on cost containment efforts across our portfolio, and improving our overall capital structure and making select investments in our existing "non-core" assets to maximize their value. To the extent we are able to generate cash flows from operations or dispositions of assets, in addition to the cash uses outlined above, our Board of Directors has determined that it is in the best interests of the Company to seek to reinvest in assets that are more likely to generate more reliable and stable cash flows, such as multi-family assets, as part of the Company's overall strategy to optimize the value of the portfolio, enhance our options for a future potential liquidity event and maximize shareholder value. Given the nature and quality of the "non-core" assets in our portfolio as well as current market conditions, we expect this strategy will take multiple years to develop and execute.

As of September 30, 2018, our portfolio of assets consisted of two office assets, two industrial assets, five retail assets, five multi-family assets, one correctional facility, two parcels of unimproved land and one bank branch. References to the "Company," "we" or "us" are to Highlands and its predecessors, as well as all of Highlands' wholly-owned subsidiaries.

We currently have four business segments, consisting of (i) net lease, (ii) retail, (iii) multi-tenant office and (iv) multi-family. Our unimproved land and multi-family assets are presented in "other." We may have additional or fewer segments in the future to the extent we enter into additional real property sectors, dispose of property sectors, or change the character of our assets. For the complete presentation of our reportable segments, see Note 10 to our Condensed Consolidated Financial Statements for the quarters ended September 30, 2018, and 2017.

Separation from InvenTrust

As a result of the Distribution, we and InvenTrust operate separately, each as an independent company. In connection with and in order to effectuate our separation from InvenTrust, we and InvenTrust entered into a Separation and Distribution Agreement. In addition, we entered into various other agreements with InvenTrust to effect the separation and provide a framework for our relationship with InvenTrust post-separation, such as a Transition Services Agreement and an Employee Matters Agreement. These agreements provide for the allocation between us and InvenTrust of InvenTrust's assets, liabilities and obligations (including its properties, employees and tax-related assets and liabilities) attributable to periods prior to, at and after our separation from InvenTrust and govern certain relationships between us and InvenTrust after the Distribution.

Basis of Presentation

The accompanying condensed consolidated financial statements include the accounts of Highlands and its predecessors, as well as all of Highlands' wholly-owned subsidiaries (collectively, the "Company"). Wholly-owned subsidiaries generally consist of limited liability companies (LLCs) and limited partnerships (LPs). The effects of all significant intercompany transactions have been eliminated.

Our Revenues and Expenses

Revenues

Our revenues are primarily derived from rental income and expense recoveries we receive from our tenants under leases with us, including monthly rent and other property income pursuant to tenant leases. Tenant recovery income primarily consists of reimbursements for real estate taxes, common area maintenance costs, management fees and insurance costs.

Expenses

Our expenses consist of property operating expenses, real estate taxes, depreciation and amortization expense, general and administrative expenses and provision for asset impairment. Property operating expenses primarily consist of repair and maintenance, management fees, utilities and insurance (in each case, some of which are recoverable from the tenant).

Key Indicators of Operating Performance

In evaluating our financial condition and operating performance, management focuses on the following financial and non-financial indicators, discussed in further detail herein:

- Cash flow from operations as determined in accordance with GAAP;
- Economic and physical occupancy and rental rates;
- Leasing activity and lease rollover;
- Management of operating expenses;
- Management of general and administrative expenses;
- Debt maturities and leverage ratios;
- Liquidity levels;
- Funds from operations (“FFO”), a supplemental non-GAAP measure; and
- Adjusted funds from operations (“AFFO”), a supplemental non-GAAP measure.

See “Selected Financial Data” for further discussion of the Company’s use, definitions and limitations of FFO and AFFO.

Results of Operations

Comparison of the three and nine months ended September 30, 2018, and 2017

Key performance indicators are as follows:

	As of September 30,	
	2018	**2017**
Economic occupancy (a)	91.5%	83.0%
Rent per square foot (b)	$ 16.36	$ 15.57

(a) Economic occupancy is defined as the percentage of total gross leasable area for which a tenant is obligated to pay rent under the terms of its lease agreement, regardless of the actual use or occupation by the tenant of the area being leased. Actual use may be less than economic square footage.

(b) Rent per square foot is computed as annualized rent divided by the total occupied square footage at the end of the period. Annualized rent is computed as revenue for the last month of the period multiplied by twelve months. Annualized rent includes the effect of rent abatements, lease inducements and straight-line rent GAAP adjustments.

Condensed Consolidated Results of Operations

	(in thousands) Three Months Ended September 30,				(in thousands) Nine Months Ended September 30,			
	2018	2017	Increase/(Decrease)		2018	2017	Increase/(Decrease)	
Net income	$ 12,389	$ 80,796	$ (68,407)	(84.7)%	$ 12,849	$ 189,362	$ (176,513)	(93.2)%

Net income decreased by $68.4 million to $12.4 million for the three months ended September 30, 2018 from $80.8 million for the three months ended September 30, 2017, primarily as a result of the 2017 gain on extinguishment of debt associated with the AT&T-St. Louis asset in the amount of $77.5 million. Additional factors contributing to the reduction in net income include a reduction in revenues related to property dispositions in the amount of $1.7 million and other income which decreased $1.5 million primarily related to the collection of a previously written-off construction deposit, net of legal fees, related to one of the land parcels located in Orlando, Florida during 2017. The reductions were partially offset by gain on the sale of investment properties in the amount of $12.5 million related to the sale of one of our retail assets and one of our other assets during the third quarter of 2018.

Net income decreased by $176.5 million to $12.8 million for the nine months ended September 30, 2018, from net income of $189.4 million for the nine months ended September 30, 2017 primarily as a result of the 2017 gain on extinguishment of debt associated with the deed of assumption and extinguishment of the debt associated with the Dulles Executive Plaza, AT&T-Hoffman Estates and AT&T-St. Louis assets, in the amount of $194.4 million. In addition, contributing to the variance is a reduction in operating income related to asset dispositions by $3.7 million and the reduction in other income discussed above in the amount of $1.5 million. These reductions were partially offset by gain on the sale of investment properties in the amount of $12.6 million and a reduction in interest expense by $9.9 million related to the disposition of assets and the payoff of debt associated with one of the retail assets.

Operating Income and Expenses

	(in thousands) Three Months Ended September 30,				(in thousands) Nine Months Ended September 30,			
	2018	2017	Increase/(Decrease)		2018	2017	Increase/(Decrease)	
Income:								
Rental income	$ 9,323	$ 10,901	$ (1,578)	(14.5)%	$ 26,401	$ 38,260	$ (11,859)	(31.0)%
Tenant recovery income	2,123	1,973	150	7.6 %	5,991	5,640	351	6.2 %
Other property income	203	129	74	57.4 %	725	823	(98)	(11.9)%
Total revenues	11,649	13,003	(1,354)	(10.4)%	33,117	44,723	(11,606)	(26.0)%
Operating Expenses:								
Property operating expenses	2,353	2,395	(42)	(1.8)%	6,648	8,383	(1,735)	(20.7)%
Real estate taxes	1,388	1,352	36	2.7 %	3,628	5,908	(2,280)	(38.6)%
Depreciation and amortization	3,406	3,288	118	3.6 %	9,753	13,788	(4,035)	(29.3)%
General and administrative expenses	2,594	2,089	505	24.2 %	9,776	8,763	1,013	11.6 %
Provision for asset impairment	—	485	(485)	(100.0)%	—	1,197	(1,197)	(100.0)%

Property Income and Operating Expenses

Rental income consists of monthly rent, straight-line rent adjustments, and amortization of acquired above and below market leases, pursuant to tenant leases. Tenant recovery income consists of reimbursements for real estate taxes, common area maintenance costs, management fees, and insurance costs. Other property income consists of lease termination fees and other miscellaneous property income. Property operating expenses consist of regular repair and maintenance, management fees, utilities, and insurance (in each case, some of which are recoverable from the tenant).

Total revenues decreased by $1.4 million in the three months ended September 30, 2018 compared to the same period in 2017 as a result of the disposition of the AT&T-St. Louis asset during 2017 as part of cooperative foreclosure processes and the sale of one of our multi-tenant office assets. Partially offsetting these reductions is rental revenue related to the multi-family assets acquired during 2017 and 2018 and an increase in occupancy at one of the office assets.

Total revenues decreased by $11.6 million in the nine months ended September 30, 2018 compared to the same period in 2017 because of the factors discussed above. Another factor contributing to these reductions was the loss of all rental income at one of the correctional facilities during the first quarter of 2017 because the tenant elected not to renew their lease, leaving such property vacant.

Property operating expenses were primarily consistent in the three months ended September 30, 2018 compared to the same period in 2017.

Property operating expenses decreased by $1.7 million in the nine months ended September 30, 2018 compared to the same period in 2017 primarily as a result of the property dispositions discussed above offset by increases in expense related to two office assets and the multi-family asset acquisitions.

Real Estate Taxes

Real estate taxes were primarily consistent during the three months ended September 30, 2018 compared to the same period in 2017.

Real estate taxes decreased $2.3 million for the nine months ended September 30, 2018 compared to the same period in 2017 as a result of the property dispositions discussed above. Additional factors contributing to the reductions were the sale of one of the parcels of land during the fourth quarter of 2017, a reduction in the assessed value of one of the correctional facilities vacated during the first quarter 2017 and an adjustment of 2017 taxes for one of our previously disposed net lease assets.

Depreciation and Amortization

Depreciation and amortization increased by $0.1 million for the three months ended September 30, 2018 compared to the same period in 2017 as a result of the acquisition of multi-family assets discussed above. A decrease of $4.0 million in depreciation and amortization for the nine months ended September 30, 2018 compared to the same period during the prior year is primarily a result of the dispositions discussed above partially offset by increases related to the multi-family asset acquisitions.

General Administrative Expenses

General and administrative expenses increased by $0.5 million to $2.6 million for the three months ended September 30, 2018 from $2.1 million for the three months ended September 30, 2017, which is primarily related to the hiring of our new Chief Financial Officer.

General and administrative expenses increased by $1.0 million to $9.8 million for the nine months ended September 30, 2018 from $8.8 million for the nine months ended September 30, 2017 primarily related to the factors discussed above.

Provision for Asset Impairment

The provision for asset impairment variance in the amount of $0.5 million and $1.2 million during the three and nine months ended September 30, 2018, respectively, was attributed to impairment taken on one of the multi-tenant office assets and one of the parcels of land during 2017. No such impairments were noted in the three and nine month period ended September 30, 2018.

Non-Operating Income and Expenses

	(in thousands)				(in thousands)			
	Three Months Ended September 30,				Nine Months Ended September 30,			
	2018	2017	Increase/(Decrease)		2018	2017	Increase/(Decrease)	
Non-operating income and expenses:								
Interest income	$ 81	$ 18	$ 63	350.0 %	$ 371	$ 75	$ 296	394.7 %
Gain (loss) on sale of investment properties	12,276	(29)	12,305	42,431.0 %	12,301	(32)	12,333	38,540.6 %
(Loss) gain on extinguishment of debt	(1,199)	77,466	(78,665)	(101.5)%	(1,199)	194,366	(195,565)	(100.6)%
Other income	23	1,489	(1,466)	(98.5)%	23	1,492	(1,469)	(98.5)%
Interest expense	(700)	(1,542)	(842)	(54.6)%	(2,114)	(13,230)	(11,116)	(84.0)%

Interest Income

Interest income increased by $0.1 million and $0.3 million during the three and nine months ended September 30, 2018, respectively, as compared to the same period in 2017 as a result of enhanced cash management practices.

Gain (Loss) on Sale of Investment Properties

During the three and nine months ended September 30, 2018, the gain on sale of investment properties was $12.3 million, which is primarily related to Highlands' sale of one of our retail assets and one of our other assets. No such gains were recorded during the three and nine months ended September 30, 2017.

(Loss) Gain on Extinguishment of Debt

The loss on extinguishment of debt during the three and nine months ended September 30, 2018 is related to prepayment penalties on the payoff of mortgage debt for the retail asset sold, discussed above.

During the three and nine months ended September 30, 2017, the gain on extinguishment of debt was $77.5 million and $194.4 million, respectively, which is attributed to the sale of one and three of our investment properties, respectively, discussed above.

Other Income

Other income decreased by $1.5 million for the three and nine months ended September 30, 2018 primarily related to the collection of a previously written-off construction deposit, net of legal fees, related to our land parcel located in Orlando, Florida during 2017.

Interest Expense

Interest expense decreased by $0.8 million to $0.7 million for the three months ended September 30, 2018 from $1.5 million for the three months ended September 30, 2017 primarily because of reductions attributed to the property dispositions discussed above.

Interest expense decreased by $11.1 million to $2.1 million for the nine months ended September 30, 2018 from $13.2 million for the nine months ended September 30, 2017 as a result of the property dispositions discussed above.

Leasing Activity

Our primary source of funding for our property-level operating activities and debt payments is rent collected pursuant to our tenant leases. The following table represents lease expirations as of September 30, 2018:

Lease Expiration Year	Number of Expiring Leases	Gross Leasable Area (GLA) of Expiring Leases (Sq. Ft.)	Annualized Rent of Expiring Leases (in thousands)	Percent of Total GLA	Percent of Total Annualized Rent	Expiring Rent/Square Foot
2018	6	3,300	$ 65	0.2%	0.2%	$ 19.70
2019	11	156,257	2,063	7.8%	6.1%	13.20
2020	26	443,162	12,541	22.1%	37.0%	28.30
2021	18	196,896	3,533	9.8%	10.4%	17.94
2022	13	238,382	3,497	11.9%	10.3%	14.67
2023	6	40,513	467	2.0%	1.4%	11.53
2024	3	103,800	920	5.2%	2.7%	8.86
2025	5	33,377	414	1.7%	1.2%	12.40
2026	8	31,655	731	1.6%	2.2%	23.09
2027	11	644,937	7,263	32.1%	21.4%	11.26
Month to Month	4	12,911	205	0.6%	0.6%	15.88
Thereafter	20	104,537	2,219	5.2%	6.5%	21.23
	131	2,009,727	$ 33,918	100.0%	100.0%	$ 16.88

The following table represents new and renewed leases that commenced in the nine months ended September 30, 2018.

	# of Leases	Gross Leasable Area	Rent per square foot	Weighted Average Lease Term
New	6	129,405	$ 27.27	8.47
Renewals	5	47,344	$ 9.97	4.67
Total	11	176,749	$ 22.64	7.45

During the nine months ended September 30, 2018, eleven new leases and renewals commenced with gross leasable area totaling 176,749 square feet. The weighted average lease term for new and renewal leases was 8.47 and 4.67 years, respectively.

Liquidity and Capital Resources

As of September 30, 2018, we had $42.0 million of cash and cash equivalents, and $2.0 million of restricted escrows.

Our principal demands for funds have been or may be:

- to pay the operating expenses of our assets;
- to pay our general and administrative expenses;
- to pay for acquisitions;
- to pay for capital commitments;
- to fund distributions;
- to service or pay-down our debt; and
- to fund capital expenditures and leasing related costs.

Generally, our cash needs have been and will be funded from:

- cash flows from our investment assets;
- proceeds from sales of assets; and
- proceeds from debt.

Our assets have lease maturities within the next two years that are likely to reduce our cash flows from operations. In particular, 22.6% of our revenue for the nine months ended September 30, 2018 is derived from a net lease with The GEO Group, Inc. on our Hudson correctional facility asset, which lease expires in January of 2020. There is no assurance that we will be able to re-lease this asset at comparable rates or on comparable terms, or at all.

We may, from time to time, repurchase our outstanding equity and/or debt securities, if any, through cash purchases or via other transactions. Such repurchases or transactions, if any, will depend on our liquidity requirements, contractual restrictions, and other factors. The amounts involved may be material.

Borrowings

The table below presents, on a condensed consolidated basis, the principal amount, weighted average interest rates and maturity date (by year) on our mortgage debt, as of September 30, 2018 (dollar amounts are stated in thousands).

Fixed rate mortgage debt maturing during the year ended December 31,	As of September 30, 2018	Weighted average interest rate, fixed
2019	$ —	—%
2020	—	—%
2021	—	—%
2022	9,413	5.24%
Thereafter	26,183	4.56%
Total	$ 35,596	4.74%

As of September 30, 2018 and December 31, 2017, no debt is recourse to the Company, although the Company or its subsidiaries may act as guarantor under customary, non-recourse carve-out clauses in our wholly-owned property owning subsidiaries' mortgage loans.

Our ability to pay off our mortgages when they become due is, in part, dependent upon our ability either to refinance the related mortgage debt or to sell the related asset. With respect to each loan, if the applicable wholly-owned property-owning subsidiary is unable to refinance or sell the related asset, or in the event that the estimated asset value is less than the mortgage balance, the applicable wholly-owned property-owning subsidiary may, if appropriate, satisfy a mortgage obligation by transferring title of the asset to the lender or permitting a lender to foreclose.

Volatility in the capital markets could expose us to the risk of not being able to borrow on terms and conditions acceptable to us for refinancing.

Mortgage loans outstanding as of September 30, 2018 and December 31, 2017 were $35.6 million and $55.9 million, respectively, and had a weighted average interest rate of 4.74% per annum. For the three and nine months ended September 30, 2018, we had no additional borrowings secured by mortgages on our assets.

Summary of Cash Flows

Comparison of the nine months ended September 30, 2018 and September 30, 2017

	(in thousands) Nine Months Ended September 30,	
	2018	2017
Cash provided by operating activities	$ 10,855	$ 13,498
Cash used in investing activities	(525)	(24,031)
Cash used in financing activities	(22,324)	(37,296)
Decrease in cash, cash equivalents and restricted cash	(11,994)	(47,829)
Cash, cash equivalents and restricted cash, at beginning of period	56,007	64,163
Cash, cash equivalents and restricted cash, at end of period	$ 44,013	$ 16,334

Cash provided by operating activities was $10.9 million and $13.5 million for the nine months ended September 30, 2018, and 2017, respectively, and was generated primarily from operating income from property operations. Cash provided by operating activities decreased $2.6 million when comparing to the same period in 2017 primarily as a result of the disposition of assets during 2017.

Cash used in investing activities was $0.5 million and $24.0 million for the nine months ended September 30, 2018 and 2017, respectively. Cash used in investing activities decreased $23.5 million when comparing to the same period in 2017, primarily as a result of the proceeds received from the sale of investment properties partially offset by the increase in the acquisition of investment properties.

Cash used in financing activities was $22.3 million and $37.3 million for the nine months ended September 30, 2018 and 2017, respectively. Cash used in financing activities for the nine months ended September 30, 2018 was primarily related to the payoff of mortgage debt in the amount of $19.5 million and prepayment penalties in the amount of $1.1 million related to the sale of one of our retail assets. Cash used in financing activities for the nine months ended September 30, 2017 was primarily due to principal payments on mortgage debt of $6.0 million and the payoff of mortgage debt in the amount of $30.3 million related to one of our retail assets.

We consider all demand deposits, money market accounts and investments in certificates of deposit and repurchase agreements with a maturity of three months or less, at the date of purchase, to be cash equivalents. We maintain our cash and cash equivalents at financial institutions. The condensed combined account balances at one or more institutions exceed the Federal Depository Insurance Corporation (“FDIC”) insurance coverage and, as a result, there is a concentration of credit risk related to amounts on deposit in excess of FDIC insurance coverage.

Distributions

For the nine months ended September 30, 2018 and 2017, no cash distributions were paid by Highlands.

Off-Balance Sheet Arrangements

As of September 30, 2018 and December 31, 2017, we had no off-balance sheet arrangements.

Selected Financial Data

The following table shows our condensed consolidated selected financial data relating to our condensed consolidated historical financial condition and results of operations. Such selected data should be read in conjunction with the condensed consolidated financial statements and related notes appearing elsewhere in this report (dollar amounts are stated in thousands, except per share amounts).

	As of	
	September 30, 2018	December 31, 2017
Balance Sheet Data:		
Total assets	$ 322,784	$ 329,617
Mortgage loans, net	$ 35,088	$ 55,273

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
Operating Data:				
Total revenues	$ 11,649	$ 13,003	$ 33,117	$ 44,723
Net income	$ 12,389	$ 80,796	$ 12,849	$ 189,362
Net income per common share, basic and diluted	$ 0.01	$ 0.09	$ 0.01	$ 0.22
Balance Sheet Data:				
Cash, cash equivalents and restricted cash	$ 44,013	$ 16,334	$ 44,013	$ 16,334
Long-term obligations (a)	$ 35,088	$ 55,432	$ 35,088	$ 55,432
Supplemental Measures (unaudited):				
Funds from operations (b)	$ 3,519	$ 84,600	$ 10,301	$ 204,406
Adjusted funds from operations (b)	$ 4,718	$ 7,134	$ 11,500	$ 10,040
Cash Flow Data:				
Net cash flows provided by operating activities	$ 5,167	$ 2,856	$ 10,855	$ 13,498
Net cash flows provided by (used in) investing activities	$ 11,827	$ (22,568)	$ (525)	$ (24,031)
Net cash flows used in financing activities	$ (20,908)	$ (1,096)	$ (22,324)	$ (37,296)

(a) Includes mortgages payable.

(b) The National Association of Real Estate Investment Trusts ("NAREIT"), an industry trade group, has promulgated a non-GAAP financial measure known as Funds From Operations, or FFO. As defined by NAREIT, FFO is net income (loss) in accordance with GAAP excluding gains (or losses) resulting from dispositions of properties, plus depreciation and amortization and impairment charges on depreciable property. We have adopted the NAREIT definition in our calculation of FFO as management considers FFO a widely accepted and appropriate measure of performance for REITs. FFO is not equivalent to our net income or loss as determined under GAAP.

Since the definition of FFO was promulgated by NAREIT, management and many investors and analysts have considered the presentation of FFO alone to be insufficient. Accordingly, in addition to FFO, we also use Adjusted Funds From Operations, or AFFO as a measure of our operating performance. We define AFFO, a non-GAAP financial measure, to exclude from FFO adjustments for gains or losses related to early extinguishment of debt instruments as these items are not related to our continuing operations. By excluding these items, management believes that AFFO provides supplemental information related to sustainable operations that will be more comparable between other reporting periods and to other public, non-traded REITs. AFFO is not equivalent to our net income or loss as determined under GAAP.

In calculating FFO and AFFO, impairment charges of depreciable real estate assets are added back even though the impairment charge may represent a permanent decline in value due to decreased operating performance of the applicable property. Further, because gains and losses from sales of property are excluded from FFO and AFFO, it is consistent and appropriate that impairments, which are often early recognition of losses on prospective sales of property, also be excluded.

We believe that FFO and AFFO are useful measures of our properties' operating performance because they exclude noncash items from GAAP net income. Neither FFO nor AFFO is intended to be an alternative to "net income" nor to "cash flows from operating activities" as determined by GAAP as a measure of our capacity to pay distributions. Other REITs may use alternative methodologies for calculating similarly titled measures, which may not be comparable to our calculation of FFO and AFFO. The following section presents our calculation of FFO and AFFO to net income (in thousands):

	Three Months Ended September 30, 2018	Three Months Ended September 30, 2017	Nine Months Ended September 30, 2018	Nine Months Ended September 30, 2017
Net income	$ 12,389	$ 80,796	$ 12,849	$ 189,362
Depreciation and amortization related to investment assets	3,406	3,288	9,753	13,813
Impairment of investment properties	—	485	—	1,197
(Gain) loss on sale of investment properties, net	(12,276)	29	(12,301)	32
Funds from operations	$ 3,519	$ 84,600	$ 10,301	$ 204,406
Loss (gain) on extinguishment of debt	1,199	(77,466)	1,199	(194,366)
Adjusted funds from operations	$ 4,718	$ 7,134	$ 11,500	$ 10,040

Use and Limitations of Non-GAAP Financial Measures

FFO and AFFO do not represent cash generated from operating activities under GAAP and should not be considered as an alternative to net income or loss, operating profit, cash flows from operations or any other operating performance measure prescribed by GAAP. Although we present and use FFO and AFFO because we believe they are useful to investors in evaluating and facilitating comparisons of our operating performance between periods and between REITs that report similar measures, the use of this non-GAAP measure has certain limitations as an analytical tool. This non-GAAP financial measure is not a measure of our liquidity, nor is it indicative of funds available to fund our cash needs, including our ability to fund capital expenditures, contractual commitments, working capital, service debt or make cash distributions. This measurement does not reflect cash expenditures for long-term assets and other items that we have incurred and will incur. This non-GAAP financial measure may include funds that may not be available for management's discretionary use due to functional requirements to conserve funds for capital expenditures, property acquisitions and other commitments and uncertainties. This non-GAAP financial measure, as presented, may not be comparable to non-GAAP financial measures as calculated by other real estate companies. Additionally, the Company believes the information included in the above table provides useful supplemental information that may facilitate comparisons of the Company's ongoing operating performance between periods, as well as between REITs that include similar disclosure.

We compensate for these limitations by separately considering the impact of these excluded items to the extent they are material to operating decisions or assessments of our operating performance. Our reconciliation to the most comparable GAAP financial measures, and our condensed consolidated statements of operations and cash flows, include interest expense, capital expenditures and other excluded items, all of which should be considered when evaluating our performance, as well as the usefulness of our non-GAAP financial measure. This non-GAAP financial measure reflects an additional way of viewing our operations that we believe, when viewed with our GAAP results and the reconciliation to the corresponding GAAP financial measure, provides a more complete understanding of factors and trends affecting our business than could be obtained absent this disclosure. We strongly encourage investors to review our financial information in its entirety and not to rely on a single financial measure.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Not applicable.

Item 4. Controls and Procedures

Disclosure Controls and Procedures

As required by Rule 13a-15(b) and Rule 15d-15(b) under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), our management, including our principal executive officer and our principal financial officer evaluated, as of September 30, 2018, the effectiveness of our disclosure controls and procedures as defined in Rules 13a-15(e) and Rule 15d-15(e) of the Exchange Act. Based on that evaluation, our principal executive officer and our principal financial officer concluded that our disclosure controls and procedures, as of September 30, 2018, were effective at a reasonable assurance level for the purpose of ensuring that information required to be disclosed by us in this Quarterly Report is recorded, processed, summarized and reported within the time periods specified by the rules and forms of the Exchange Act and is accumulated and communicated to management, including our principal executive officer and our principal financial officer, as appropriate, to allow timely decisions regarding required disclosures.

Changes in Internal Control Over Financial Reporting.

There has been no change in the Company's internal control over financial reporting during the quarter ended September 30, 2018 that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

Part II.

Item 1. Legal Proceedings

We are from time to time involved in legal actions arising in the ordinary course of business. We are not currently involved in any legal or administrative proceedings that we believe are likely to have a material adverse effect on our business, results of operations or financial condition.

Item 1A. Risk Factors

Not applicable.

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

None.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

None.

Item 6. Exhibits

The exhibits filed in response to Item 601 of Regulation S-K are listed on the Exhibit Index attached hereto and are incorporated herein by reference.

EXHIBIT NO.	DESCRIPTION
3.1	Articles of Amendment and Restatement of Highlands REIT, Inc. (incorporated by reference to Exhibit 4.1 to the Company's Registration Statement on Form S-8, filed with the Securities and Exchange Commission on April 27, 2016)
3.2	Amended and Restated Bylaws of Highlands REIT, Inc. (incorporated by reference to Exhibit 3.2 to the Company's Current Report on Form 8-K, filed with the Securities and Exchange Commission on April 28, 2016)
31.1*	Certification of Principal Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2*	Certification of Principal Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1*	Certification of Principal Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2*	Certification of Principal Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
101.INS*	XBRL Instance Document
101.SCH*	XBRL Taxonomy Extension Schema Document
101.CAL*	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF*	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB*	XBRL Taxonomy Extension Label Linkbase Document
101.PRE*	XBRL Taxonomy Extension Presentation Link Document

* Filed as part of this Quarterly Report on Form 10-Q.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities and Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Signature	Title	Date
/s/ Richard Vance Richard Vance	President and Chief Executive Officer (Principal Executive Officer)	November 6, 2018
/s/ Paul Melkus Paul Melkus	Executive Vice President and Chief Financial Officer (Principal Financial Officer)	November 6, 2018

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Section 2: EX-31.1 (EXHIBIT 31.1)

Exhibit 31.1

Certification of Principal Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

I, Richard Vance, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of Highlands REIT, 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 registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer(s) 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; and

(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 materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer(s) 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 6, 2018 /s/ Richard Vance
Name: Richard Vance
Title: President and Chief Executive Officer
(Principal Executive Officer)

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Section 3: EX-31.2 (EXHIBIT 31.2)

Exhibit 31.2

Certification of Principal Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

I, Paul Melkus, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of Highlands REIT, 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 registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer(s) 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; and

(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 materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer(s) 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 6, 2018 /s/ Paul Melkus
Name: Paul Melkus
Title: Executive Vice President and Chief Financial Officer
(Principal Financial Officer)

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Section 4: EX-32.1 (EXHIBIT 32.1)

Exhibit 32.1

Certification of Principal Executive Officer
Pursuant To 18 U.S.C. Section 1350,
as Adopted Pursuant to
Section 906 of The Sarbanes-Oxley Act of 2002

In connection with the Quarterly Report on Form 10-Q of Highlands REIT, Inc. (the "Company") for the period ended September 30, 2018 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), the undersigned officer of the Company certifies, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that to such officer's knowledge:

(1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: November 6, 2018

/s/ Richard Vance
Name: Richard Vance
Title: President and Chief Executive Officer (Principal Executive Officer)

A signed original of this written statement required by Section 906 has been provided to the Company and will be retained by the Company and furnished to the Securities and Exchange Commission or its staff upon request.

The foregoing certification is being furnished solely pursuant to 18 U.S.C. Section 1350 and is not being filed as a part of the Report or on a separate disclosure document.

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Section 5: EX-32.2 (EXHIBIT 32.2)

Exhibit 32.2

Certification of Principal Financial Officer
Pursuant To 18 U.S.C. Section 1350,
as Adopted Pursuant to
Section 906 of The Sarbanes-Oxley Act of 2002

In connection with the Quarterly Report on Form 10-Q of Highlands REIT, Inc. (the “Company”) for the period ended September 30, 2018 as filed with the Securities and Exchange Commission on the date hereof (the “Report”), the undersigned officer of the Company certifies, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that to such officer’s knowledge:

(1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date:	November 6, 2018	/s/ Paul Melkus
		Name: Paul Melkus
		Title: Executive Vice President and Chief Financial Officer (Principal Financial Officer)

A signed original of this written statement required by Section 906 has been provided to the Company and will be retained by the Company and furnished to the Securities and Exchange Commission or its staff upon request.

The foregoing certification is being furnished solely pursuant to 18 U.S.C. Section 1350 and is not being filed as a part of the Report or on a separate disclosure document.

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