

View of the Market

Volume XVI/Issue
2/February 2024

Strategy and Insight for the Commercial Real Estate Industry

A Publication of Paramount Capital Corporation

INSIDE THIS ISSUE

Real Estate Focus:

- The Office Blues
- Update on the U.S. Hotel Market
- Preparing CRE Property Budgets
- CRE Books by Our Editor, Joseph Ori
- CRE Financing Rates Courtesy of Paramount Capital Corporation

CRE Deal Focus:

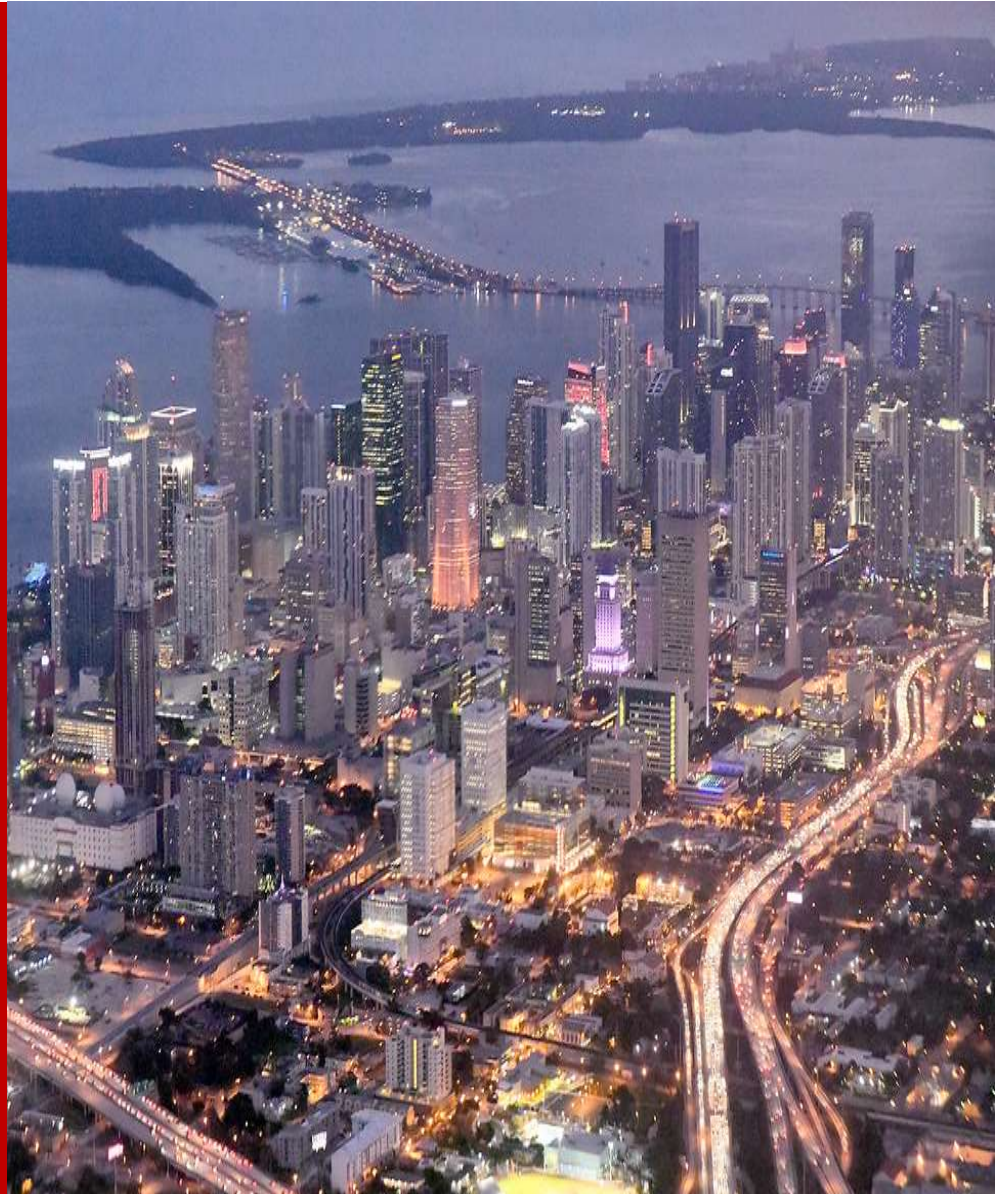
- CRE Deals of the Month

Corporate Finance Focus:

- The Daily Drucker
- An Introduction to ROIC for an Operating Company

REIT Focus:

- REIT Return Statistics
- REIT Review: W.P. Carey Inc., a Net Lease REIT



Strategy and Insight for the Commercial Real Estate Industry

A Publication of Paramount Capital Corporation

REAL STATE FOCUS

The Office Blues

The national office market has been in distress the last few years, with most of the defaults and foreclosures in the urban areas with high crime, outmigration, and poor quality of life. The primary culprits are New York, Chicago, Washington D.C., Seattle, Portland, downtown Los Angeles, and San Francisco. Per the Mortgage Bankers Association as of the third quarter of 2023, there were \$4.6 trillion in CRE loans outstanding in the U.S., of which the office sector represents approximately seventeen percent of the total or \$782 billion. As we have stated in many prior issues of VOM, the national default rate of aggregate loans of \$4.6 trillion is only about 2.0% or \$92 billion. However, the default rate for office building loans is higher at about 4.0% or \$31 billion. Both of these are currently very manageable for the economy and the CRE market.

Due to the turmoil in the office market, many buildings have been foreclosed and are trading at significant markdowns, often at less than the debt on the property. The table below shows some of the key distressed buildings sold around the country since 2022.

Property	Estimated Sale Discount	Square Footage	Former Owner
1. Grand + Nash, El Segundo, CA	60%	164,000	Steel Wave/Barings
2. 1700 E. Walnut, El Segundo, CA	56%	120,000	CBRE Inv. Management
3. 400/450 No. Brand, Glendale, CA	60%	443,000	Kennedy Wilson
4. Griffin Towers, Santa Ana, CA	36%	540,000	Blackstone

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5. 300 South Wacker Dr., Chicago, IL	38%	512,000	Golub and Alcion Ventures
6. 350 California St., San Francisco, CA	75%	300,000	SKS and Swig Company
7. The Clark Building, Bethesda, MD	77%	335,000	Stonebridge and Rockwood Capital
8. 300 W. Adams, Chicago, IL	89%	250,000	Morgan Stanley
9. 60 Spear St., San Francisco, CA	62%	157,000	Clarion Partners
10. Westwood Terrace, Los Angeles, CA	<u>52%</u>	<u>164,000</u>	Goldman Sachs
Average Discount/Total Square Feet	<u>60.5%</u>	<u>2,985,000</u>	

The discounted sales above are just a sample of the beleaguered office market and represent a discount from the original purchase price of over \$500 million.

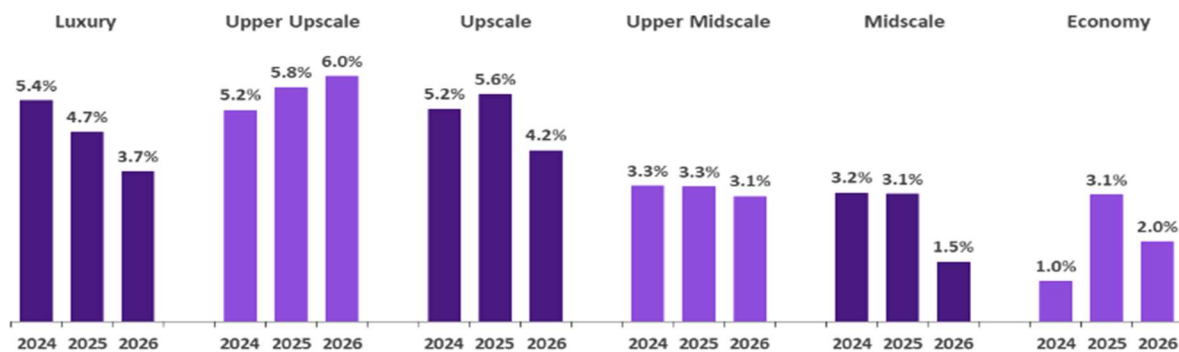
Update on the U.S. Hotel Market

The U.S. hotel market continues to perform well after the demand shock from the pandemic in 2020. According to Smith Travel Research, the growth in ADR and RevPAR in 2024 will be 3.1% and 4.1%, respectively. The sector is showing solid fundamentals with high leisure and business demand. Many consumers have shifted their spending from “stuff” to experiences and services of which travel is a key component. Although the economy is slowing somewhat, the job market is still very strong. The hotel segments that will see the highest RevPAR growth in 2024 are luxury at 5.4%, upper upscale at 5.2%, upscale at 5.2% and upper midscale at 3.3%.

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A Publication of Paramount Capital Corporation

The investment market should be strong in 2024 with reduced inflation expectations and lower interest rates during the last half of the year. We here at VOM are seeing increased interest from lenders and equity investors for hotel loans both acquisition and construction, especially in the high-growth Sunbelt markets. Many owners of hotels need relief from financial pressures including the inability to refinance at appropriate levels, depleted capex reserves and the roll-off of interest rate collars and swaps. This is welcome news to hotel REITs, private equity firms and institutions seeking to diversify their current office holdings into hotels. The most coveted segments for investment are urban and resort luxury assets and extended stay assets in Sunbelt markets. Cap rates for luxury assets are in the 6.0%-8.0% range and extended stay are in the 7.0% to 9.0% range. The table below from Smith Travel Research and CoStar shows the annual gains in RevPAR for the various hotel segments.



Strategy and Insight for the Commercial Real Estate Industry

A Publication of Paramount Capital Corporation

Preparing CRE Property Budgets

One of the most important management duties when owning a CRE asset is to prepare annual operating budgets for the property and portfolio. With the depressed volume of transactions in the industry since the Fed began raising interest rates, many CRE owners are focused on their existing properties, with strategies and procedures to increase the cash flow and net operating income (NOI). Most CRE owners and developers begin the budgeting process in September or October of the current year for the next year. There are typically three budgeting methodologies used by most CRE firms. These are baseline budgeting, zero-based budgeting, and NOI budgeting. The most common budgeting technique used in the CRE industry and corporate finance is baseline budgeting.

Baseline budgeting is an accounting method that begins with last year's actual operating statement amounts and makes adjustments to revenue and expenses to arrive at next year's budgeted amounts. This is the most common and easiest-to-use budgeting technique in the CRE industry but is flawed as it assumes that future operations are entirely based on last year's numbers and increase at an inflation rate for the new year. Many CRE firms that own apartment properties just apply an inflation factor to increase revenues and expenses, subject to specific fixed or contractual lease income and expense adjustments, to determine next year's budget amounts. For commercial properties, the tenant leases must be extended and projected with CRE software like Argus and expenses are increased by an inflation factor. Although baseline budgeting is the easiest and the most preferred methodology, it can also be the most inaccurate. It often leads to unrealistic budget numbers and large variances with actual operations.

The second budgeting accounting method used is zero-based budgeting. Under zero-based budgeting, the property income and expenses for the upcoming year are set to zero and a brand-new budget is calculated for the new year. This budgeting method is used by a small percentage of CRE owners due to its complexity and the additional work required, but is the best budgeting method, as it forces management to "start from scratch" and create a more realistic operating

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statement. If a firm is using baseline budgeting and it finds that the budget versus actual comparison at the end of the year is way off, then it should switch to zero-based budgeting.

The last and least used budgeting technique is NOI budgeting. NOI budgeting is creating a budget by starting with a property's NOI and working backward up to the gross potential rent to complete the operating statement. This budgeting methodology is also flawed as it requires the budgeting team to meet an NOI target that in most cases may not be attainable unless there are major cuts in expenses and substantial and unrealistic increases in revenue. Many times, senior management of the real estate company forces its management and accounting teams to persuasively try and meet an NOI number that is impractical and unattainable, in a bid to hit an investor return. This is a dodgy technique and can create accounting irregularities and mismanagement.

Get Your Copy of Three Great CRE Books by Our Editor, Joseph Ori

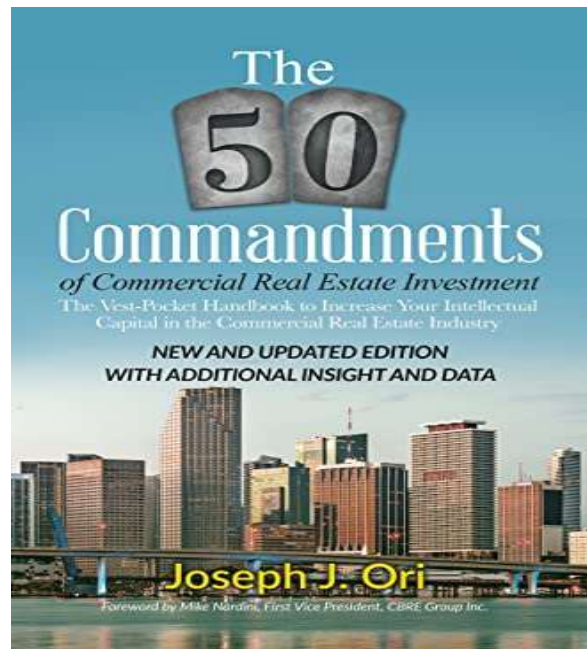
The editor of this newsletter, Joseph Ori, is pleased to offer his three CRE books for sale, "The Fifty Commandments of Commercial Real Estate Investment" Edition I and II and "Commercial Real Estate Investment for Pros (and Dummies Too!)." All books are available on Amazon and other book outlets in Kindle, and soft and hardcover from \$8.99 to \$24.99.

Both editions of The Fifty Commandments of Commercial Real Estate Investment compile the choice pieces of advice Mr. Ori has amassed over 35 years in the CRE industry. Mr. Ori lists essential dos and don'ts, mistakes, and successful strategies with a mixture of critical analysis and a keen sense of satirical humor, reinforced by his encyclopedic knowledge of the commercial real estate environment. Mr. Ori covers all areas of the industry. Commercial real estate investment, finance, development, capital markets, and management tactics are all given his full attention, as are leasing, financial analysis, and institutional investments. He applies his commandments to all property types, including apartments, office buildings, shopping centers, industrial warehouses, lodging properties, and senior housing.

Strategy and Insight for the Commercial Real Estate Industry

A Publication of Paramount Capital Corporation

Commercial Real Estate Investment for Pros (and Dummies Too!) discusses the history, the various financial players, legal and financial structures, property types, modern portfolio theory and the financial metrics of commercial real estate investment and the commercial real estate industry. The book includes numerous charts and analyses of the industry and a step-by-step breakdown of the commercial real estate analysis and investment process. The book is perfect reading for the experienced real estate pro and also understandable to the real estate novice or someone new to the industry.

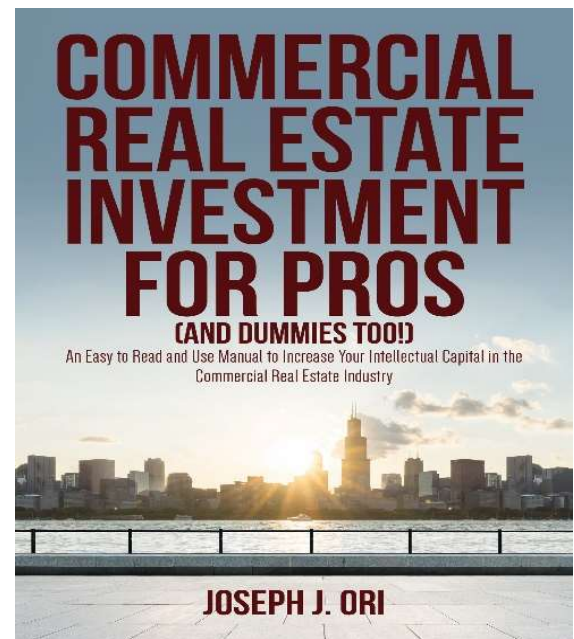
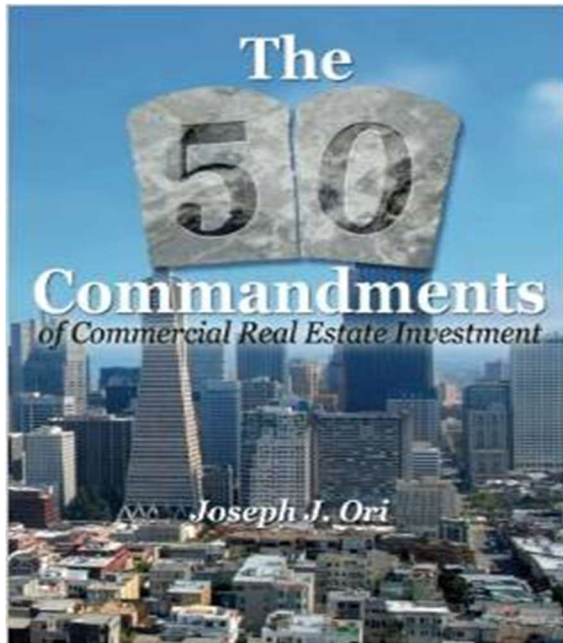


View of the Market

Volume XVI/Issue
2/February 2024

Strategy and Insight for the Commercial Real Estate Industry

A Publication of Paramount Capital Corporation



CRE Financing Rates

Loan Type	Mortgage Rate	Maximum Amortization	Term (years)	Maximum LTV
Permanent Loans	5.87%-10.50%+	30	10	70%
Conduit-CMBS	5.88%-7.49%+	30	10	70%
Bridge Loans	6.50%-14.50%+	Interest Only	1-3	80%
Construction Loans	10.00%-15.00%+	Interest Only	1-4	70%
Insurance Co. Loans	5.38%-7.89%+	30	10	70%
Fannie Mae/Freddie Mac	4.98%-5.79%+	30	10	80%

View of the Market

Volume XVI/Issue
2/February 2024

Strategy and Insight for the Commercial Real Estate Industry

A Publication of Paramount Capital Corporation

Commercial Loan Index Rates	
Prime Rate	8.50%
30-Day SOFR (secured overnight funding rate)	5.32%
1 Year Swap	5.65%
10 Year Swap	3.87%
5 Year Treasury	3.99%
10 Year Treasury	4.11%
Federal Funds Rate	5.25%



Short-term interest rates have remained stable with the 30-day SOFR rate at 5.32%, however, the ten-year treasury rate has increased to 4.11%. The Federal Reserve met on January 30-31, 2024, and kept the funds rate at 5.25%. We still believe that the Fed will begin to lower rates in the second quarter of 2024, which will create a mini-boom in CRE. The above financing rates and data are courtesy of Paramount Capital Corporation and feel free to contact Joseph Ori, Executive Managing Director, Paramount Capital Corporation, jjo@paramountcapitalcorp.com, for your real estate capital needs.

View of the Market

Volume XVI/Issue
2/February 2024

Strategy and Insight for the Commercial Real Estate Industry

A Publication of Paramount Capital Corporation

CRE Deal Focus

CRE Deals of the Month

Purchaser/ Sponsor	Seller	Property/ Deal	Price	Description
Blackstone	Tricon Residential	Taking Tricon Residential Private	\$3.5B	Acquisition of Tricon, a Toronto-based single-family homeowner.
Longpoint	Seagis Property Group	Industrial Portfolio	\$262M	A 25-building industrial portfolio with 1.4 million square feet.
Tishman Speyer and Bellco Capital	HealthWPC Properties	Callan Ridge, San Diego, CA	\$236M	A two-building life science campus with 185,000 square feet.
Hennick & Co.	Unknown	Bridge Tower Place, New York, NY	\$153M	A 120,000-square-foot retail property leased to Home Depot and Starbucks.

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Griffis Residential	Unknown	Platform at Union Station, Denver, CO	\$125M	A 287-unit apartment complex built in 2015.
Hines Global Income Trust, Inc.	Unknown	Hanover Diridion, San Jose, CA	\$117M	A 249-unit apartment complex built in 2021.
The Connor Group	JP Morgan	Broadstone Olivine, Littleton, CO	\$100M	A 326-unit apartment complex built in 2021.
Sequoia Equities	Security Properties and Pacific Life Insurance Co.	Tessera at Orenco Station, Hillsboro, OR	\$99M	A 304-unit apartment complex built in 2014.
Hyde Development and Mortenson Properties	Hartford Financial Services Group	Peoria Business Center, Denver, CA	\$73M	A three-building office complex with 592,572 square feet.

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Hines Global Income Trust	Unknown	IBM 500 Campus, Durham, NC	\$66M	A 774,000- square foot office property fully leased to IBM
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CORPORATE FINANCE FOCUS

The Daily Drucker

One of the most popular corporate thinkers and management consultants in the last hundred years is Peter Drucker. He passed away in 2005 at 92 years old, but during his illustrious career, published over thirty-five books, and his corporate and management ideas have had a profound impact on shaping the modern corporation and management science. For the next twenty-four issues of VOM, we will highlight some of his insights and motivations in corporate management, personnel, and the knowledge worker from one of his last books, *The Daily Drucker*.

I. Individual Development

The important thing is not that you have rank, but that you have responsibility. The person with the most responsibility for an individual's development is the person himself, not the boss. The first priority for one's own development is to strive for excellence. The most effective road to self-renewal is to look for the unexpected success and run with it. The critical factor for success is accountability, holding yourself accountable.

II. Place Yourself in the Right Organization

Where do I belong as a person? To develop yourself, you have to be doing the right work in the right kind of organization. If you don't belong where you currently work, the next question is why? Is it because you can't accept the values of the organization or is the organization corrupt?

Strategy and Insight for the Commercial Real Estate Industry

A Publication of Paramount Capital Corporation

The right decision is to quit if you are in the wrong place, if it is basically corrupt, or if your performance is not being recognized.

III. Attracting Knowledge Workers

In attracting and holding knowledge workers, we already know what does not work: bribery. Attracting and holding knowledge workers have become two of the central tasks of people management. Of course, knowledge workers need to be satisfied with their pay, because dissatisfaction with income and benefits is a powerful disincentive. Knowledge workers expect continuous learning and continuous training. Above all, they want respect, not so much for themselves, but for their area of knowledge.

IV. Legitimacy of Management

It is the purpose of the organization, and the grounds of management authority, to make human strength productive. It is the task of management to make the institutions of the society of organizations, beginning with business enterprise, perform for the society, and economy, for the community and for the individual, alike. This requires, first, that managers know their discipline. It requires that they know management. The first task of the business manager is, therefore, economic performance. But at the same time, she faces the tasks of making the work productive and the worker achieving, and of providing for the quality of life for society and individual.

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A Publication of Paramount Capital Corporation

An Introduction to ROIC for an Operating Company

There are many metrics and ratios used to determine the profitability and value of an operating company. Some of these are; return on equity (net income/stockholders' equity), price-earnings ratio (stock price/earnings per share), EBITDA, earnings before interest, taxes, depreciation, and amortization, multiple (enterprise value/EBITDA) and net profit margin (net income/sales). One important and often overlooked metric is a company's return on invested capital or ROIC. There are a few different versions of ROIC, but the one we favor here at VOM is the net operating profit after tax (NOPAT) divided by the book value of long-term debt and stockholder's equity less any excess cash/investments. We like using NOPAT as the numerator as it does not include the effects of interest expense and includes income taxes which are an operating expense. The denominator represents the historical investment of debt and equity capital in the company less any excess cash/investments, which are assumed will be used to pay down any debt and were made to generate the ROIC.

Investors in a company's stock are part business owners and are interested in knowing the following questions regarding the return on invested capital.

- How much capital has been invested in the business?
- What is the rate of return that the company has historically earned on that investment?
- How much capital will the company need to grow in the future?
- What is the cost of the company's capital?

View of the Market

Volume XVI/Issue
2/February 2024

Strategy and Insight for the Commercial Real Estate Industry

A Publication of Paramount Capital Corporation

The first two questions can be answered by a thorough analysis of the company's financial statements. Using the ROIC definition above, the amount of capital and rate of return earned on that capital can be calculated and compared over several years and to competitor and industry averages. The amount of capital needed to grow in the future depends on the company's sales and profitability and its weighted average cost of capital. These metrics can easily be calculated and also compared to competitor and industry averages.



Analyzing and rating companies by their ROIC is a great way to compare the earnings power of each company and select investment opportunities. We look for companies with a ROIC more than 25% for long periods of time. The ROIC for a few of the largest companies in the S&P 500 as of their latest 10K is shown below.

Company	ROIC
McDonalds	18.7%
Alphabet (Google)	39.7%
Coca Cola	17.1%

View of the Market

Volume XVI/Issue
2/February 2024

Strategy and Insight for the Commercial Real Estate Industry

A Publication of Paramount Capital Corporation

Nvidia	23.8%
Costco	34.5%

REIT Statistics

Current REIT statistics for 12/31/23 per NAREIT and NCREIF are included in the table below. Please note the all-equity REIT return over 20 years includes three CRE downturns, the Great Recession, the retail and store closure meltdown and the current higher interest rate regime.

<i>Period</i>	<i>All REITs</i>	<i>All Equity REITs</i>	<i>NCREIF NPI Levered Index</i>	<i>S&P 500</i>	<i>NASDAQ Composite</i>
			<i>(Q4-23)</i>		
2023	11.50%	11.40%	-12.15%	26.30%	44.60%
1-Year	11.50%	11.40%	-12.15%	26.30%	44.60%
5-Year	7.10%	7.60%	4.41%	15.70%	18.80%
10-Year	7.70%	8.00%	7.97%	12.00%	14.80%
20-Year	7.70%	8.30%	8.82%	9.70%	10.60%
Market Capitalization	\$1.37T	\$1.31T	\$371B	NA	NA
Dividend Yield	4.25%	3.92%	NA	1.42%	NA

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A Publication of Paramount Capital Corporation

REIT Review

Summary

This REIT valuation is on W.P. Carey Inc., (“WPC”), a publicly-traded REIT that is the leading owner of commercial real estate comprised primarily of single-tenant industrial, warehouse, retail, and self-storage facilities. WPC owns 1,424 properties aggregating 173 million square feet. In September 2023, WPC announced a plan to exit the office assets within the portfolio by (i) spinning off 59 office properties into Net Lease Office Properties, a Maryland real estate investment trust, so that it became a separate publicly-traded REIT, and (ii) implementing an asset sale program to dispose of 87 office properties retained by WPC, which is targeted to be completed in the first half of 2024. Seventy-nine of the 87 office properties have been sold as of the date of the 10K, for gross proceeds of approximately \$608.1 million. On November 1, 2023, WPC completed the spin-off, contributing 59 office properties to the REIT.

Property Developments and Tenants

As of Q4-23, WPC committed to fund four redevelopment or expansion projects, for an aggregate amount of \$84.1 million. WPC currently expects to complete the projects in 2024 and 2025.

Corporate Data

WPC is traded on the NYSE, is incorporated in Maryland, and is located in New York, NY. WPC has 100.5 million common shares outstanding and a market capitalization of approximately \$6,400 billion. WPC's debt is rated BBB+ by Standard & Poor's, Inc., and Baa1 by Moody's.

Management

Jasen E. Fox, 50, CEO

Jason E. Fox was appointed Chief Executive Officer and as a member of W. P. Carey's Board of Directors in 2018. Prior to his current position, Mr. Fox served as President from 2015 to 2017, Head of Global Investments from 2015 to 2016 and Co-Head of Global Investments from 2012 to 2015. During his tenure, Mr. Fox has overseen more than \$10 billion in acquisitions. Before joining W. P. Carey in 2002, Mr. Fox worked at the Spectrem Group, a consulting and M&A advisory firm in San Francisco. Prior to Spectrem, Mr. Fox spent two years teaching

Strategy and Insight for the Commercial Real Estate Industry

A Publication of Paramount Capital Corporation

mathematics and physics at The Hotchkiss School in Connecticut. He is a magna cum laude graduate of the University of Notre Dame, where he earned a B.S. in Civil Engineering and Environmental Science. He also serves on the advisory board of the Fitzgerald Institute for Real Estate at the University of Notre Dame, a center that focuses on educating and inspiring the next generation of real estate professionals. Mr. Fox received his M.B.A. from Harvard Business School.

Ownership

Top Institutional Holders	Shares (000's)	%
The Vanguard Group, Inc.	30,130	13.78
Blackrock, Inc.	15,810	7.23
State Street Corporation	10,150	4.64
Cohen & Steers, Inc.	5,880	2.69
JP Morgan Chase and Company	5,350	2.45

Ownership Breakdown	
% Of Shares Held by All Insiders and 5% Owners	1.10
% Of Shares Held by Institutional & Mutual Fund Owners	68.09
Number of Institutions Holding Shares	1,023

All amounts above per Yahoo Finance

View of the Market

Volume XVI/Issue
2/February 2024

Strategy and Insight for the Commercial Real Estate Industry

A Publication of Paramount Capital Corporation

Financial Analysis and Valuation

Select financial data for WPC per the 2023 10K and supplemental information.

(In millions where applicable)

Financial Data	Amounts
Real Estate Assets, Gross	\$17,882
Total Assets	\$17,976
Property Debt (at weighted average interest rates of approximately 3.2%)	\$8,144
Stockholders' Equity	\$8,706
Revenue	\$1,741
Net Income (Loss)	\$708
Cash Flow from Operations	\$1,073
Unsecured Credit Facility (\$2B with \$403M used)	\$1,597
Market Capitalization	\$13,460
Property Debt to:	
Gross Real Estate Assets	46%
Market Capitalization	60%
Enterprise Value	38%
Dividend and Yield (\$3.44/sh.)	6.0%
Shares Sold Short (in millions per Yahoo Finance)	8,380

View of the Market

Volume XVI/Issue
2/February 2024

Strategy and Insight for the Commercial Real Estate Industry

A Publication of Paramount Capital Corporation

Valuation Methodology	
2023 Real Estate Revenue	\$1,741
2023 Real Estate Operating Expenses (excluding depreciation, amortization, interest expense, impairment charges plus G&A expenses)	<u>\$329</u>
2023 Net Operating Income	\$1,412
Proforma Net Operating Income at 103%	\$1,454
Projected Average Cap Rate	<u>7.0%</u>
Projected Value of Real Estate Assets	\$20,771
Add: Net Operating Working Capital (at book value)	<u>\$604</u>
Equity Investments (at book value)	<u>\$354</u>
Total Projected Value of the Assets of the Company	\$21,729
Less: Total Debt per Above	<u>(\$8,144)</u>
Projected Net Asset Value of the Company	<u>\$13,585</u>
Common Shares Outstanding, 218.6M	
Projected NAV Per Share	\$62
Market Price Per Share on 2/15/24	\$57
Premium (Discount) to NAV	(8%)

View of the Market

Volume XVI/Issue
2/February 2024

Strategy and Insight for the Commercial Real Estate Industry

A Publication of Paramount Capital Corporation

Financial Metrics

The gross real estate assets, property debt, revenues, net income, funds from operations, return on invested capital, dividend coverage, and dividends per share for WPC for the years 2018 through 2023 are shown in the table below.

(Millions except dividend and per share amounts)	2018	2019	2020	2021	2022	2023
Gross Real Estate Assets	\$13,493	\$13,848	\$14,858	\$15,918	\$18,700	\$17,882
Property Debt	\$6,378	\$6,053	\$6,695	\$6,791	\$7,877	\$8,144
Revenues	\$779	\$1,172	\$1,177	\$1,312	\$1,479	\$1,741
Net Income (Loss)	\$411	\$305	\$455	\$409	\$599	\$708
Funds from Operations (FFO)	\$634	\$856	\$896	\$866	\$1,105	\$1,061
Return on Invested Capital (1)	5.2%	8.0%	6.9%	8.3%	7.2%	8.9%
Dividend Coverage (2)	1.39	1.21	1.23	1.13	1.32	1.16
Dividends Paid Per Share	\$4.09	\$4.14	\$4.172	\$4.205	\$4.24	\$4.067

- (1) This ratio is cash provided by operations plus interest expense divided by stockholder's equity plus property debt and measures the return the REIT is earning on its invested capital.
- (2) This ratio is funds from operations divided by common and preferred stock dividends and distributions to noncontrolling interests.
- (3) The dividend is currently \$.86 per quarter and reduced due to the spin-off of the office assets.

The total return of WPC year to date and through five years are shown in the chart below per NAREIT:

WPC Total Return	2023	1-Yr	3-yr	5-Yr
	-9.88%	-9.88%	3.65%	6.16%

Strategy and Insight for the Commercial Real Estate Industry

A Publication of Paramount Capital Corporation

As shown above, our net asset value per share for WPC is \$63/sh., compared to a market price of \$57/sh. Current average cap rates for net lease properties per our industry experience and CBRE's Cap Rate Survey are in the 6.0% to 9.0% range, depending on the credit of the tenant and the term of the lease. We have used an average cap rate of 7.0% due to WPC's diversified portfolio of net leased assets.

Strengths:

- An attractive dividend yield of 6.0%.
- The stock is trading at an 8.0% discount to the NAV.
- A low debt to enterprise value of 38%.

Concerns:

- REIT prices will decline if interest rates increase.

Recommendation:

WPC is trading at a discount of 8.0% to our NAV per share, but we are not recommending the purchase of the stock.

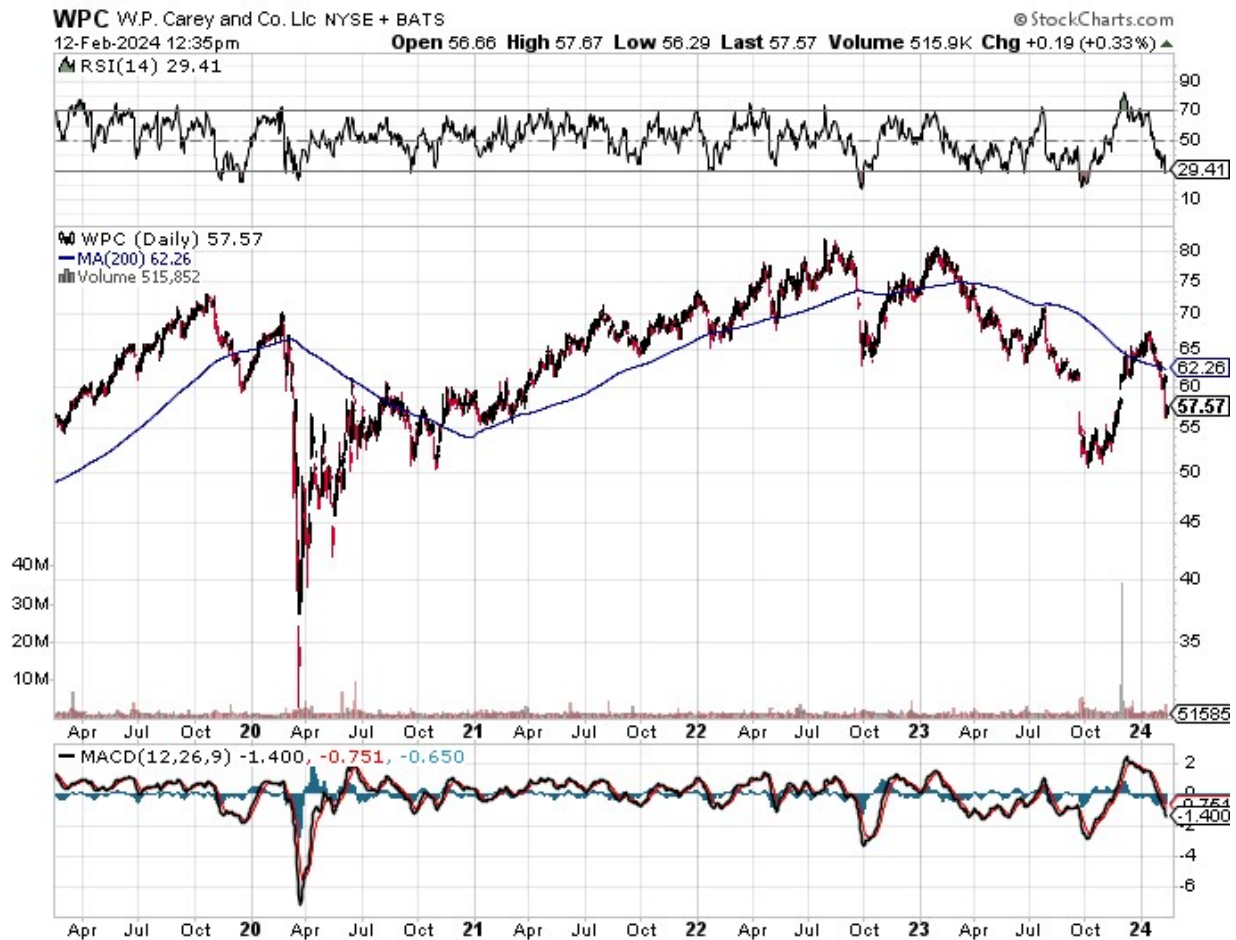
View of the Market

Volume XVI/Issue
2/February 2024

Strategy and Insight for the Commercial Real Estate Industry

A Publication of Paramount Capital Corporation

A five-year price chart for WPC is shown below:



View of the Market

Volume XVI/Issue
2/February 2024

Strategy and Insight for the Commercial Real Estate Industry

A Publication of Paramount Capital Corporation

REIT FOCUS REVIEWS IN PRIOR ISSUES OF VOM ARE AS FOLLOWS:



1. Camden Property Trust, Inc., January 2022
2. Healthcare Trust of America, Inc., February 2022
3. Simon Property Group, Inc., March 2022
4. Brandywine Realty Trust, April 2022
5. Rexford Industrial Realty, Inc., May 2022
6. Host Hotels & Resorts, June 2022
7. The Macerich Company, July 2022

Strategy and Insight for the Commercial Real Estate Industry

A Publication of Paramount Capital Corporation

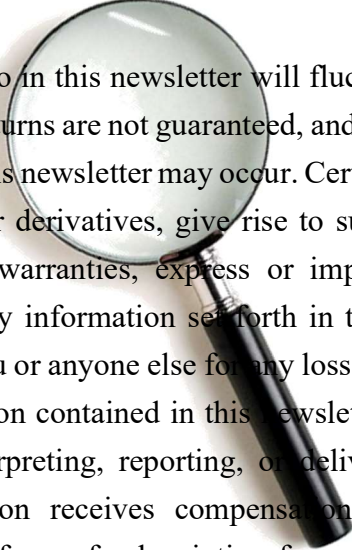
8. Hudson Pacific Properties, Inc., August 2022
9. Kilroy Realty Corporation, September 2022
10. Realty Income Corporation, October 2022
11. Federal Realty Trust, November 2022
12. Equity Residential, December 2022
13. STAG Industrial, January 2023
14. Brixmor Property Group, Inc., February 2023
15. Mid-America Apartment Communities, March 2023
16. Office Properties, Trust, April 2023
17. Spirit Realty Capital, Inc., May 2023
18. Cousins Properties, Inc., June 2023
19. Tanger Factory Outlet Centers, Inc., July 2023
20. Paramount Group, Inc., August 2023
21. Broadstone Net Lease, Inc., September 2023
22. Apartment Income REIT Corp., October 2023
23. Kite Realty Group Trust, November 2023
24. Alexandria Real Estate Equities, Inc., December 2023
25. Agree Realty Corporation, January 2024

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