# View of the Market

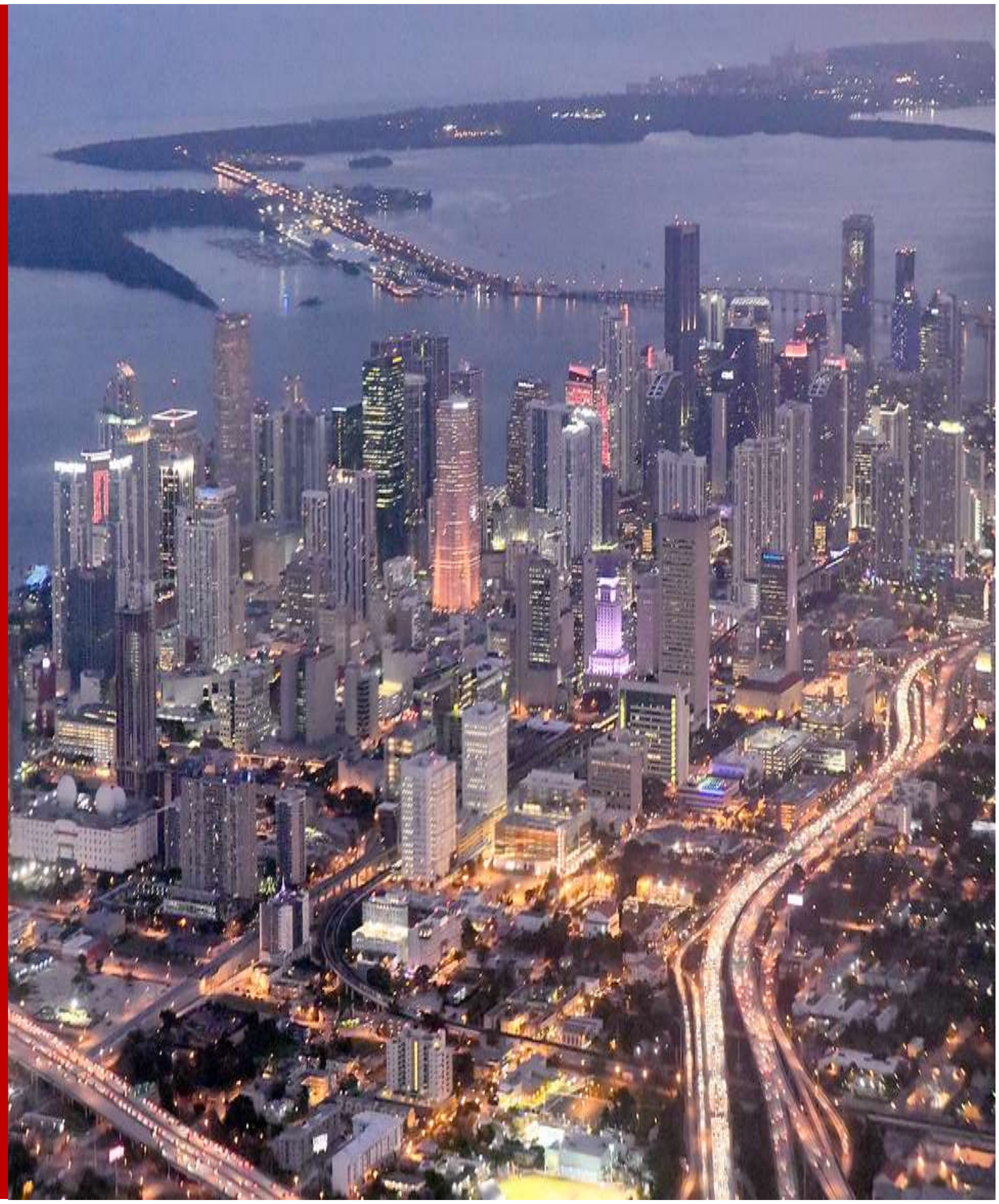
Volume XV/Issue 10/ October 2023

Strategy and Insight for the Commercial Real Estate Industry

A Publication of Paramount Capital Corporation

## INSIDE THIS ISSUE





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## ***REAL STATE FOCUS***

### The Revaluation of CRE Assets

The Federal Reserve has increased the federal funds rate eleven times since March 2022 with the rate currently at 5.25%. The stock market has been going through its own revaluation as investors are deciding what the appropriate price is for a stock based on higher risk-free interest rates (U.S. Treasuries). Rising risk-free rates increase the cost of capital and when a property's net operating income or cash flow to equity is discounted at this higher cost of capital, the value of a property declines. Since most CRE assets are leveraged with the cost of debt rising from about 3.5%-4.5%, two years ago, to 6.0%-7.0% today, this also requires much higher cap rates and lower prices.

The same calculation has also happened to public CRE assets with REIT stocks down 24.95% in 2022 and up a minuscule 1.54% through 8/23. Private CRE assets have also declined in value with office assets down by about 30% and other assets like apartments, industrial and retail down by about 10%-20%. Whenever there is a downward price valuation in real estate or any private asset, the sellers are usually behind the curve as there is not a public venue to mark the asset to market on a daily basis. Many sellers still believe the Class A apartments and industrial real estate they bought at a 4% cap rate a couple of years ago, can be sold at the same return.
A seller will typically place a property on the market at the 4% cap rate, but all potential buyers will be offering a price based on a higher return of 6.0% or 7.0%. This will be sticker shock to the seller. The seller will in many cases take the property off the market, in anticipation of the good old days of 4% cap rates returning and continue to own and manage the property. We doubt those days will return anytime soon unless the Fed pivots and begins lowering the funds rate in 2024.

The good news with higher cap rates is for buyers of CRE. There are currently more than $150 billion in private real estate funds in the U.S. looking for deals. These buyers will enjoy the opportunity to finally buy good real estate at reasonable risk-adjusted cap rates.

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## The Booming Industrial Market is Beginning to Soften

The darling investment of the CRE business during the last several years has been the industrial real estate market. Since the end of the Great Recession in 2012, the industrial sector began to grow and beginning in 2018, the industrial market boomed. During the last two years, there has also been a construction boom with over 600 million square feet built. Industrial properties have been “hot” because of the booming economy, which creates additional demand for goods and the warehouse and distribution centers to store them. In addition, the growth of e-commerce and the online purchasing of goods has increased the demand for “last mile” industrial properties and large multi-football-sized distribution warehouses to store the goods. Average cap rates for industrial properties since 2018 were 4.0%-5.0% but have increased to 6.0%-7.0%+ today.
Key industrial statistics for the second quarter of 2023 per broker, Cushman and Wakefield are as follows:

1. 12-month YoY rent growth, 16.1%
2. Q2-23 absorption, 44.9M square feet
3. Q2-23 vacancy rate, 4,1%
4. Q2-23 asking rent, $9.59 psf
6. Q2-23 under construction, 624.3M square feet

The industrial real estate market is very diverse with different property types including; warehouse and distribution centers, refrigeration/cold storage centers, office/flex buildings, manufacturing properties and R&D facilities. All of these properties are in demand today with the greatest activity for large distribution warehouses in close proximity to seaports and airports. Most industrial properties are located in suburban or rural areas, where land costs are low, there is easy access to the freeway system and it’s easier to obtain entitlements to build industrial in these locations. Although the industrial market has been strong, it is beginning to soften and will see lower rents, less new construction, and an increase in cap rates during the next few years.

Although the Q-2 industry metrics above look good, current data reflects a weaker outlook. New construction for 2023 is now estimated at about 375MSF versus 624MSF, year over year rent growth will be up by only 5.0%-6.0% versus 16%, vacancy will increase to 5.0%+ from 4.1%, and asking rent will decline about 5.0%-7.0% from $9.59PSF. These are still strong numbers, but not as robust as the past few years. Some of the large industrial REITs are experiencing tenant retention rates of 70%, which is unheard of for large single-tenant properties, which typically see tenant turnover of less than 10%. However, industrial assets that are leased and available to purchase at 6.0% cap rates and higher should be purchased.

## Update on REIT Returns

The REIT sector had negative returns in 2022 with the FTSE-NAREIT All Equity REITs down 24.95%, However, returns in 2023 have bounced back somewhat with the index up 1.54% through August. The table below shows key REIT sectors and the 2021, 2022 and August 2023 returns. Note the bounce back in returns for all these key REIT sectors.

| REIT Sector | 2021 Total Return | 2022 Total Return | 8/23 Total Return |
|---|---:|---:|---:|
| FTSE NAREIT All Equity REITs | 41.30% | -24.95% | 1.54% |
| Industrial | 62.03% | -28.58% | 11.18% |
| Office | 22.00% | -37.62% | -7.48% |
| Shopping Centers | 65.05% | -12.54% | 1.63% |
| Lodging/Resorts | 18.22% | -15.31% | -0.04% |
| Data Centers | -27.97 | -27.97% | 25.31% |

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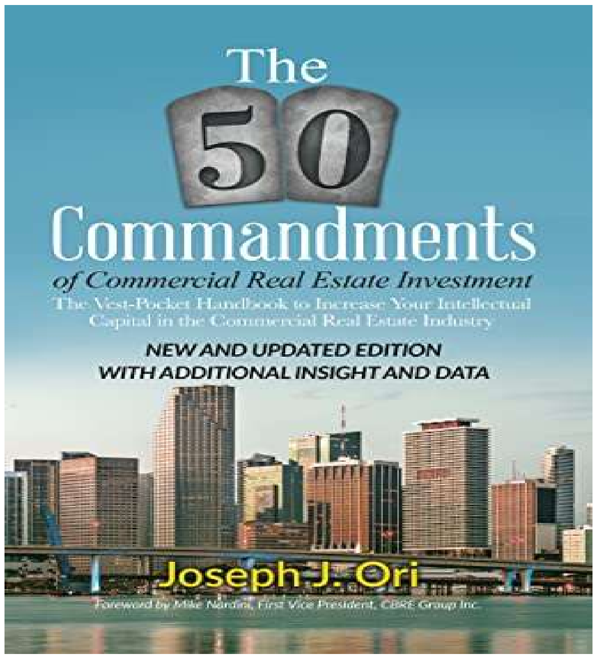
All investors should have an allocation to REIT stocks and preferably in a diversified all-equity REIT fund. The 20-year All Equity REIT return was 8.48%, which includes the current soft CRE market and the crash in prices during the Great Recession. We recommend 15%-20% of your investment portfolio in a diversified REIT fund.

## 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.

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.



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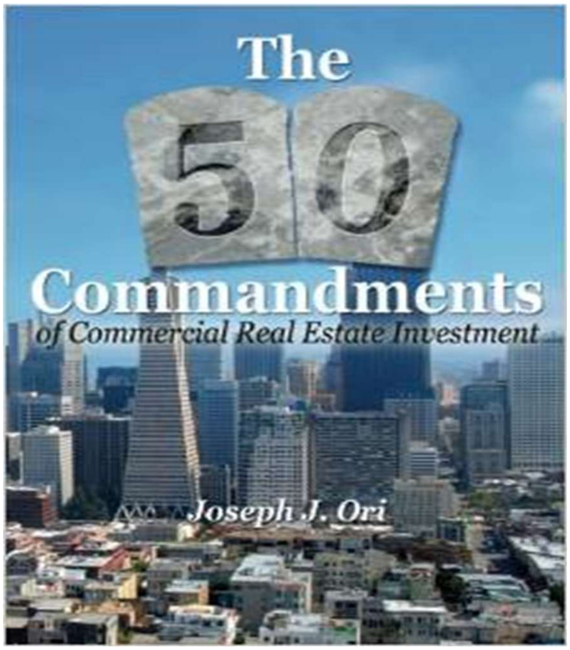


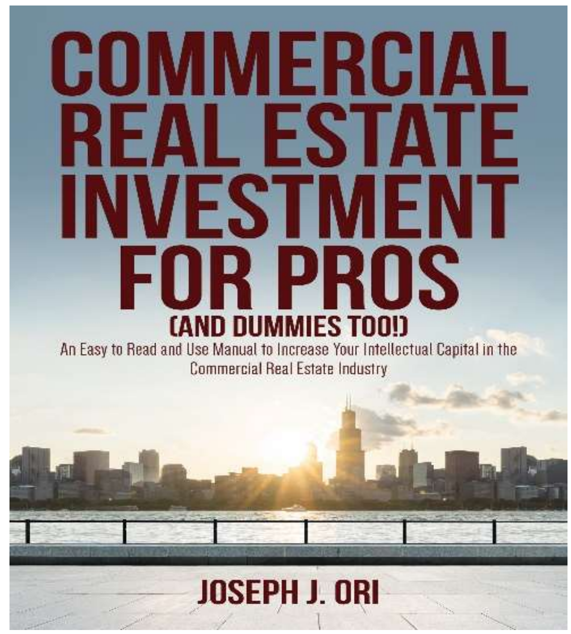

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## CRE Financing Rates

| 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%-5.02%+ | 30 | 10 | 80% |

| Commercial Loan Index Rates | |
|---|---|
| Prime Rate | 8.50% |
| 30-Day LIBOR | 5.32% |
| 30-Day SOFR (secured overnight funding rate) | 5.32% |
| 1 Year Swap | 5.64% |
| 10 Year Swap | 3.87% |
| 5 Year Treasury | 4.75% |
| 10 Year Treasury | 4.79% |
| Federal Funds Rate | 5.25% |

Short-term interest rates moderated somewhat with the 30-day SOFR rate at 5.32%. Also, the Federal Reserve will meet again from October 31st to November 1st and may increase the federal funds rate by another .25%. 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.

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# *CRE Deal Focus*

## CRE Deals of the Month

| Purchaser/ Sponsor | Seller | Property/ Deal | Price | Description |
|---|---|---|---|---|
| C&S Wholesale Grocers LLC | The Kroger Co. | Portfolio of Grocery Stores. | $1.9B | 413 grocery stores, eight distribution centers and two offices in 17 states. |
| Kayne Anderson | Synovus Bank | Medical Office Loan Portfolio. | $1.3B | A portfolio of 106 floating rate loans on 308 medical office buildings. |
| Investcorp | NA | 31-Property Portfolio of Industrial Properties. | $216M | A 1.6 million square foot industrial portfolio in five major markets. |
| Centennial Real Estate | Unibail-Rodamco-Westfield | Westfield Valencia Town Center, Santa Clarita, CA | $199M | A 1 million-square-foot shopping mall. |

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| | | | | |
|---|---|---|---|---|
| Onyx Acquisition IV LLC and Starwood | Ben Elias Industries Corp. | Light Industrial Portfolio, Loan Island, NY | $146M | A 10-property light industrial portfolio. |
| Olympus Property | The Wolff Co. | Aiya Apartments, Gilbert, AZ | $112M | A 360-unit apartment property built in 2022. |
| TruAmerica Multifamily | PCCP | 1901 E. 1st St., Santa Ana, CA | $103M | A three and five-story apartment property built in 2016 |
| GIDA | The Altman Cos. | Altis Ludlam Trail, West Miami, FL | $91M | A 312-unit apartment property built in 2021. |
| Spruce Capital Group | Harvard Investments | First Street Happy Valley, Phoenix, AZ | $88M | A 212-unit apartment property. |
| King Properties | Woodfield Development | Kelby Farms, Durham, NC | $85M | A 277-unit apartment property built in 2023. |

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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 great 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. Characteristics of the Next Society**

Every institution in the knowledge society has to be globally competitive.

The next society will be a knowledge society. Its three main characteristics will be:

- Borderlessness because knowledge travels even more effortlessly than money.
- Upward mobility, available to everyone through easily acquired formal education.
- The potential for failure as well as success. Anyone can acquire the "means of production," that is, the knowledge required for the job, but not everyone can win.

Together, those three characteristics will make the knowledge society a highly competitive one, for organizations and individuals alike.

**II. Knowledge Does Not Eliminate Skill**

Knowledge without skill is unproductive. On the contrary, knowledge is fast becoming the foundation for skill. We are using knowledge more and more to enable people to acquire skills of a very advanced kind fast and successfully. Only when knowledge is used as a foundation for skill does it become productive. Outline the skills required in your work. Analyze and refine these skills for optimum quality and productivity.

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**III. Price of Success in the Knowledge Society**

The fear of failure has already permeated the knowledge society. The upward mobility of the knowledge society comes at a high price: the psychological pressures and emotional traumas of the rat race. There can be winners only if there are losers. This was not true of earlier societies. If their work is all they have, they are in trouble. Knowledge workers therefore need to develop some serious outside interests.

**IV. The Center of the Knowledge Society**

Education will become the center of the knowledge society and schooling its key institutions. What mix of knowledge is required for everybody? What is "quality" in learning and teaching? All these will, of necessity, become central concerns of the knowledge society, and central political issues. In fact, it may not be too fanciful to anticipate that the acquisition and distribution of formal knowledge will come to occupy the place in the politics of the knowledge society that the acquisition of property and income have occupied in the two or three centuries that we have come to call the Age of Capitalism.

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## REIT Statistics

Current REIT statistics for 8/20/23 per NAREIT and NCREIF are included in the table below. Please note the solid all-equity REIT return over 20 years. REITs have been one of the best-performing asset classes historically.

| *Period* | *All REITs* | *All Equity REITs* | *NCREIF NPI Levered Index (Q2-23)* | *S&P 500* | *NASDAQ Composite* |
|---|---|---|---|---|---|
| ***8/2023*** | 1.85% | 1.54% | -5.24% | 18.73% | **34.48%** |
| ***1-Year*** | -7.59% | -7.71% | -9.99% | 15.94% | **19.85%** |
| ***5-Year*** | 3.35% | 3.79% | 6.60% | 11.12% | **12.85%** |
| ***10-Year*** | 7.12% | 7.31% | 9.41% | 12.81% | **15.78%** |
| ***20-Year*** | 7.94% | 8.48% | 9.50% | 9.93% | **10.78%** |
| ***Market Capitalization*** | $1.27T | $1.20T | $357B | NA | NA |
| ***Dividend Yield*** | 4.47% | 4.12% | NA | 1.49% | NA |

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## REIT Review

### Summary

This REIT valuation is on Apartment Income REIT Corp. ("AIRC"), a publicly-traded REIT that is focused on the ownership of stabilized multi-family properties located in top markets including eight important geographic concentrations: Boston; Philadelphia; Washington, D.C.; Miami; Denver; the San Francisco Bay Area; Los Angeles; and San Diego. AIRC owns or has interests in 73 apartment communities with 25,739 units.

### Property Information

As of June 30, 2023, the occupancy rate was 96% and the YoY increase in the net operating income was 15.5%.

### Corporate Data

AIRC is traded on the NYSE, is incorporated in Maryland, and is located in Denver, CO. AIRC has 149 million common shares outstanding and a market capitalization of approximately $4,656 billion. AIRC is an UpReit, and it owns or controls 91.3% of the interests in its operating partnership, Apartment Income REIT, L.P. AIRCs debt is rated BBB by Standard and Poor's and Baa2 by Moody's. AIRC was spun off from its prior owner, Apartment Investment and Management Co., or AIMCO, on December 15, 2020.

### Subsequent Events

After June 30, 2023, AIRC formed a joint venture with a global institutional investor by selling a 47% interest in a portfolio of 10 apartment properties in Philadelphia, Washington D.C., Denver, San Diego, and Miami with 3,093 apartment homes and average monthly rent of $2,534. In preparation for the joint venture, AIRC borrowed $611.4 million in new non-recourse property debt. The properties were contributed to the joint venture subject to this debt.

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## Management

***Terry Considine, 76, CEO***

EXPERIENCE:

Chief Executive Officer, AIR Communities (2020 - present)

Chief Executive Officer and Chairman, Aimco (1994 - December 2020 separation)

In 1975, founded and subsequently managed the predecessor companies that became Aimco at its initial public offering in 1994

QUALIFICATIONS:

Chief Executive Officer and Chairman, Aimco (July 1994 - December 2020)As a long-term investor, Terry understands the importance and fiduciary responsibilities of stewardship for the investment of the capital entrusted by others to his care.

EDUCATION:

JD, Harvard Law School

BA, Harvard

## Ownership

| Top Institutional Holders | Shares (000's) | % |
|---|---|---|
| Vanguard Group, Inc. | 21,698 | 14.54 |
| Blackrock, Inc. | 17,090 | 11.45 |
| Cohen & Steers, Inc. | 14,301 | 9.58 |
| JP Morgan Chase and Company | 12,101 | 8.11 |
| Principal Financial Group, Inc. | 8,918 | 5.98 |

| Ownership Breakdown | |
|---|---|
| % Of Shares Held by All Insiders and 5% Owners | .42% |
| % Of Shares Held by Institutional & Mutual Fund Owners | 102.2% |

| | |
|---|---|
| Number of Institutions Holding Shares | 449 |

All amounts above per Yahoo Finance

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## Financial Analysis and Valuation

Select financial data for AIRC per the Q2-23 10Q and supplemental information.

(In millions where applicable)

| Financial Data | Amounts |
|---|---|
| Real Estate Assets, Gross | $8,233 |
| Total Assets | $6,407 |
| Property Debt (at weighted average interest rates of 4.3%) | $3,684 |
| Stockholders' Equity | $2,168 |
| Revenue | $426 |
| Net Income (Loss) | ($12) |
| Cash Flow from Operations | $182 |
| Unsecured Credit Facility ($704M with $292M used) | $412 |
| Market Capitalization | $4,656 |
| **Property Debt to:** | |
| Gross Real Estate Assets | 45% |
| Market Capitalization | 79% |
| Enterprise Value | 44% |
| Dividend and Yield ($1.80/sh.) | 5.86% |
| Shares Sold Short (in millions per Yahoo Finance) | 2,510 |

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| Valuation Methodology | |
| --- | --- |
| Q2-23 Real Estate Revenue | $426 |
| Q2-23 Real Estate Operating Expenses (excluding depreciation, amortization, interest expense, impairment charges plus G&A expenses) | $166 |
| Q2-23 Net Operating Income | $260 |
| Annualized Proforma Net Operating Income at 103% | $536 |
| Projected Average Cap Rate | 6.0% |
| Projected Value of Real Estate Assets | $8,933 |
| Add: Net Operating Working Capital (at book value) | $260 |
| Total Projected Value of the Assets of the Company | $9,193 |
| Less: Total Debt Per Above | ($3.684) |
| Projected Net Asset Value of the Company | $5,509 |
| Common Shares Outstanding, 149.2M | |
| Projected NAV Per Share | **$37** |
| Market Price Per Share on 10/15/23 | **$31** |
| Premium (Discount) to NAV | **(16%)** |

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## 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 AIRC for the years 2021 through Q2-23 are shown in the table below. AIRC was spun off from AIMCO REIT on 12/15/20.

| (Millions except dividend and per share amounts) | 2018 | 2019 | 2020 | 2021 | 2022 | Q2-23 |
|---|---|---|---|---|---|---|
| Gross Real Estate Assets | NA | NA | NA | $4,205 | $5,008 | $8,233 |
| Property Debt | NA | NA | NA | $1,714 | $2,021 | $3,684 |
| Revenues | NA | NA | NA | $382 | $407 | $426 |
| Net Income (Loss) | NA | NA | NA | $102 | $122 | ($12) |
| Funds from Operations (FFO) | NA | NA | NA | $256 | $273 | $167 |
| Return on Invested Capital (1) | NA | NA | NA | 8.1% | 9.0% | NA |
| Dividend Coverage (2) | NA | NA | NA | 1.11 | 1.03 | 1.13 |
| Dividends Paid Per Share | NA | NA | NA | $1.74 | $1.80 | $1.80 |

(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 $.45 per quarter.

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

| AIRC Total Return | 8/23 | 1-Yr | 3-yr | 5-Yr |
|---|---|---|---|---|
| | 3.07% | -12.34% | NA | NA |

As shown above, our net asset value per share for AIRC is $37/sh., compared to a market price of $31/sh. Current average cap rates for apartment properties per our industry experience and CBRE's Cap Rate Survey are in the 5.0% to 8.0% range, depending on the location, quality, and age of the property. We have used an average cap rate of 6.0% due to AIRCs Class B portfolio of apartment properties.

***Strengths:***

- An attractive dividend yield of 5.86%.
- A low debt to enterprise value of 44%.
- The stock is trading at a 16% discount to our NAV.

***Concerns:***

- REIT prices will decline if interest rates increase.
- AIRC has a low dividend coverage of 1.13 times.
- AIRCs portfolio is concentrated in urban areas with high crime rates.

***Recommendation:***

AIRC is trading at a discount of 16% to our NAV per share, however, we are not recommending the purchase of the stock due to the location of many of its properties.

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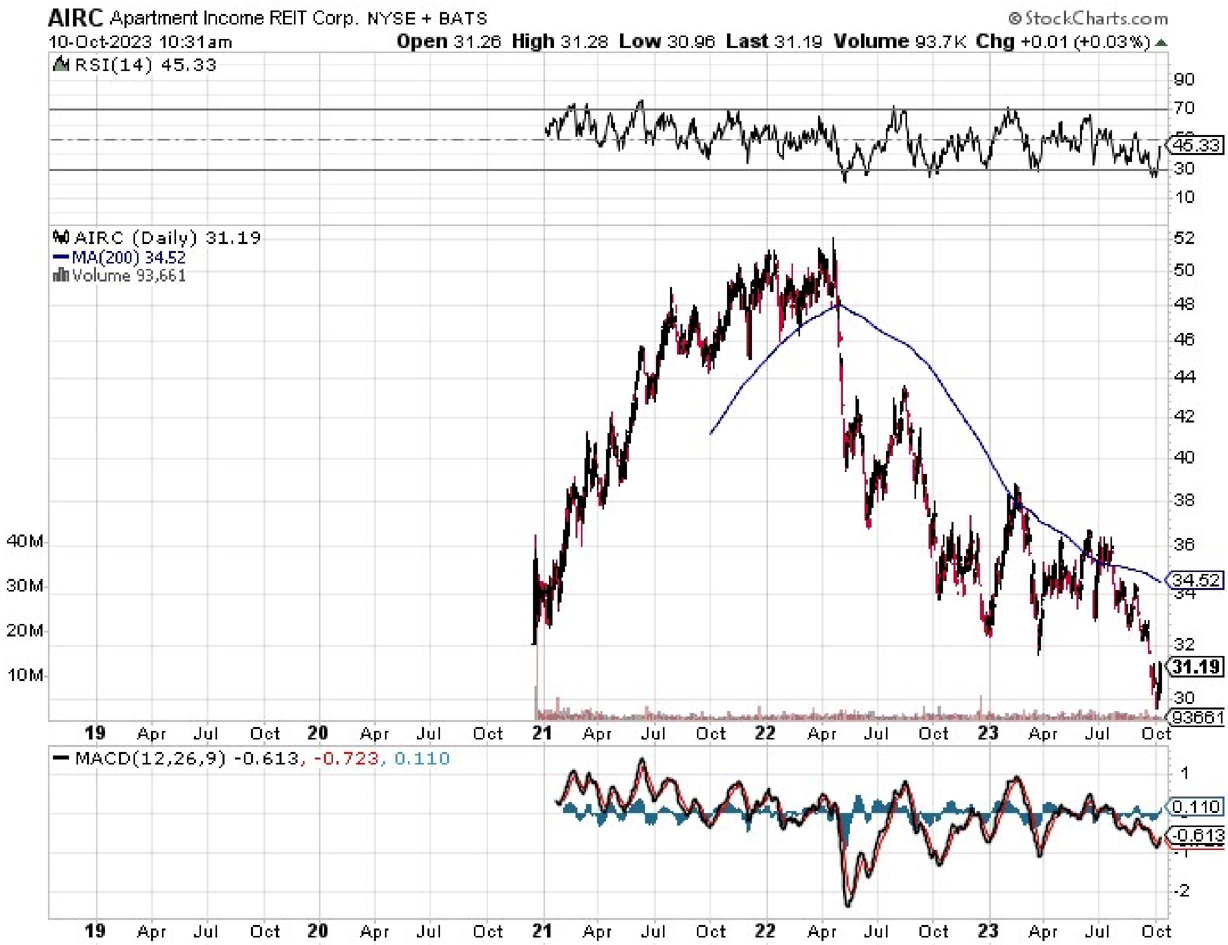
A five-year price chart for AIRC is shown below:



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

1. Cousins Properties, Inc., August 2021
2. Mid-America Apartments, Inc., September 2021
3. VEREIT, Inc., October 2021
4. Spirit Realty Capital, Inc, November 2021
5. First Industrial Realty Trust, Inc., December 2021
6. Camden Property Trust, Inc., January 2022
7. Healthcare Trust of America, Inc., February 2022
8. Simon Property Group, Inc., March 2022
9. Brandywine Realty Trust, April 2022
10. Rexford Industrial Realty, Inc., May 2022
11. Host Hotels & Resorts, June 2022
12. The Macerich Company, July 2022

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

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