

View of the Market

Volume XV/Issue
11/November
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Strategy and Insight for the Commercial Real Estate Industry

A Publication of Paramount Capital Corporation

INSIDE THIS ISSUE

Real Estate Focus:

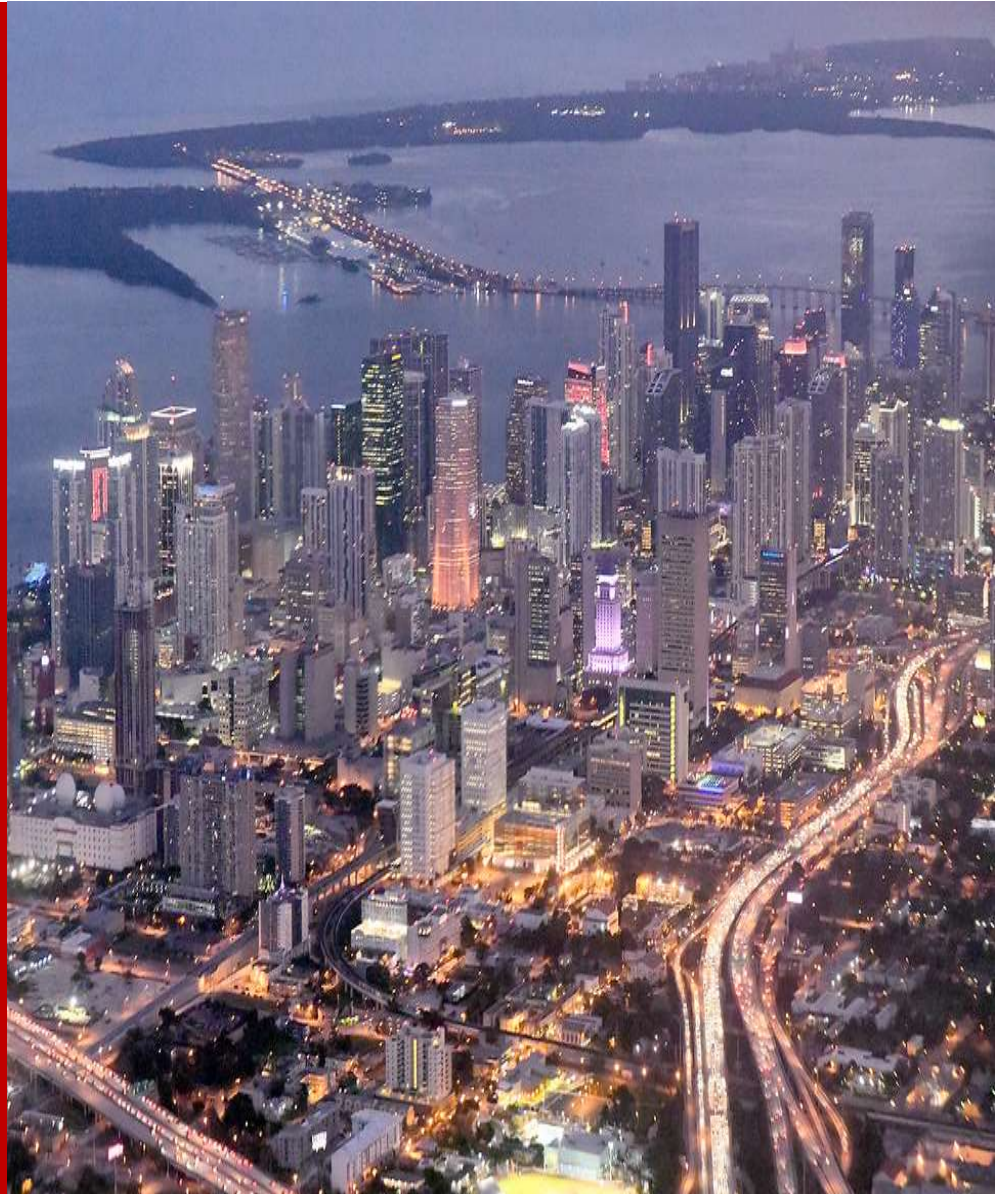
- Highlights of the 2024 Emerging Trends in CRE Report
- The Bounce Back of the Retail Sector
- What is the Highest and Best Use of CRE?
- CRE Books by Our Editor, Joseph Ori
- CRE Financing Rates Courtesy of Paramount Capital Corporation

CRE Deal Focus:

- CRE Deals of the Month

Corporate Finance Focus:

- The Daily Drucker
- REIT Return Statistics
- REIT Review: Kite Realty Group Trust, a Retail REIT



Strategy and Insight for the Commercial Real Estate Industry

A Publication of Paramount Capital Corporation

REAL STATE FOCUS

Highlights of the 2024 Emerging Trends in CRE Report

The 2024 Emerging Trends in Real Estate Report from Price Waterhouse Coopers and the Urban Land Institute has been issued and below are some of the key comments on the industry from the report.

1. A new era comes into focus, “Unbuckle your seatbelts because it’s probably going to be a slow, careful ride. Disruption won’t happen like a roller coaster. It’s gonna be slow going and you’re just gonna have to do your homework when it comes to specific details and specific places and specific property types.”
2. Interest rates will be higher for longer; the worst of inflation is behind us, and property owners must prepare for more painful property value losses.
3. Investors are eager to acquire new assets, yet sales transaction levels are way down because buyers and sellers cannot agree on pricing.
4. The most important economic/financial issues for real estate 2024 survey:
 - a. Interest rates and cost of capital
 - b. Availability of capital
 - c. Job and income growth
4. The office property sector is going through a reconsideration of its purpose and sustainable size comparable to the retail shakeout of the past decade but at much greater speed.
5. Reduced availability and greater cost of debt present significant obstacles for investors seeking to acquire new assets and developers wanting to construct new projects.

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A Publication of Paramount Capital Corporation

6. Thus far, delinquency and default rates remain at healthy levels and well below levels seen in recent recessions, though they are inching up, particularly for CMBS, life insurance companies, and banks and thrifts.

7. Housing affordability continues to reign as a top challenge for the CRE sector.

8. With downtown offices and regional malls, the traditional pillars of “Core” CRE portfolios, both suffering existential declines in tenant demand and property values, fund managers must find replacement investments.

9. “You have to look at the overarching, longer trends and make decisions about what sectors and what investment strategies you’re going to focus on based on that long-term view of basic supply and demand, with more focus on the demand side of the equation, particularly if you’re a long-term holder of real estate.”

10. The good news is that market fundamentals for senior housing are on the mend and improving steadily. Second-quarter data on senior housing trends released by NIC MAP Vision continued to show solid improvement in occupancy rates, relatively strong demand, languishing inventory growth and steady rate increases.

11. Student housing performance remains strong, but signs of moderation emerge.

12. The industrial real estate market is transitioning to a new normal after years of unprecedented and unsustainable growth. Industrial tenants are taking stock of their current portfolios and moving more cautiously into the next phase of growth.

13. With life science property inventory growing at a significant rate simultaneous with a pullback in funding, there is bound to be an impact on performance fundamentals. Even with all the headwinds, demand has so far remained strong and 60% of the construction pipeline in Q-3 2023 is pre-leased.

Strategy and Insight for the Commercial Real Estate Industry

A Publication of Paramount Capital Corporation

14. The hotel sector continues to show strong performance amid recessionary concerns and macroeconomic headwinds, highlighted by year-over-year gains in average daily room (ADR) rates and revenue per available room (RevPAR).

15. Despite challenges, retail emerges as CRE darling. Coresight reports that there will be an estimated 5,200 new stores open in 2023 and only 3,200 store closures.

16. Absorption of apartments hit record levels in recent years owing to a surge in household formation and social and demographic trends.

17. High mortgage rates have cut into mortgage activity, especially commercial banks, CMBs, and collateralized loan obligations, which were either reducing exposure to commercial properties or offering pricing that was not competitive.

18. While construction costs remain volatile month to month, cycle times for home builders are becoming more reliable, which is helping builders confidence in pricing and costs.

19. The single-family rental housing market has experienced significant growth and transformation in recent years. Deteriorating housing affordability, demographic shifts, supply constraints and increased investor activity have all contributed to a rise in demand and supply of single-family homes.

20. As demand for storage units realigns with typical historical levels, the prospect that the Federal Reserve will achieve an economic soft landing with its current monetary policies has the potential to stabilize storage renter demand moving into 2024.

This Emerging Trends report is a great read and analysis of the CRE market, the outlook for the industry and the key property types.

Strategy and Insight for the Commercial Real Estate Industry

A Publication of Paramount Capital Corporation

The Bounce Back of the Retail Sector

The CRE retail market has gone through the ringer during the last eight years with over 100,000 store closures and hundreds of bankruptcies. Retail companies that have gone bankrupt during this period include Sears, JC Penney, Toys R Us, Gymboree, Radio Shack, Forever 21, Ascena Retail Group, Bed Bath & Beyond, Rite Aid, Payless Shoes, and many others. Many pundits during this period were calling for the death of the mall and shopping center, people would not shop at stores anymore, most consumers would shop online instead of visiting a store and all 800 malls would close. Retail REIT stocks were also decimated during this period with the largest mall operator, Simon Property Group, down to \$54/share in 2020 from a high of \$227/share in 2016 and shopping center owner, Kimco Realty Corporation, saw its stock drop to \$10/share in 2020 and down from its prior high of \$22/share in 2019. It was also a common theme that the major retailers like Macy's, Kohls and Dillard's would also go out of business, but this never happened and today they are all doing very well, even in this difficult high inflation era. The returns for retail REIT stocks have been more volatile with returns as follows during the last two years and nine months in 2023.

Sector	2021	2022	9/2023
Shopping Centers	65.05%	-12.54%	-3.19%
Regional Malls	92.05%	-22.91%	-3.27%

Today, retail real estate is very healthy with U.S. retail sales rising from \$445 billion in 2019 to \$613 billion today or a 38% increase. In the retail real estate sector, neighborhood/community shopping centers are performing the best with 95%+ occupancies, high demand, especially for food/drugstore anchored centers and solid rent growth. Lifestyle, entertainment, outlet, and power centers are also doing well but less than the neighborhood group. Malls are also doing fine with a 95% occupancy rate and traffic up 12% at top-tier malls in 2022 compared to pre-pandemic levels according to retail consultant, Coresight Research. According to Costar Group, there is 12 billion square feet of retail space in the U.S., with grocery-anchored community and

Strategy and Insight for the Commercial Real Estate Industry

A Publication of Paramount Capital Corporation

neighborhood shopping centers accounting for 25% and a vacancy of only 6.0%. Power Centers account for 6.7% of total space and have a vacancy rate of a mere 4.3%.

According to Cushman & Wakefield's, Q-3 2-2023 retail report, the average vacancy rate for the entire retail sector was 5.4% a record low, average asking rent was \$23.68, also a record low, absorption was a strong 3.5 million square feet and new construction was 13.2 million square feet, all of which portend a resilient retail sector and strong consumer. CRE investors that have been afraid to acquire retail properties for the last few years should reconsider and buy retail, especially food/drug store-anchored shopping centers.

What is the Highest and Best Use of CRE?

The highest and best-use concept in the CRE industry is one of the key economic/investment principles in the sector. It posits the idea of maximum productivity and profit for a given parcel of land. In the CRE appraisal process, the appraiser first determines the highest and best use of the land and building. The appraiser then determines how the highest value for a property is arrived at and how it produces the greatest value, regardless of its actual current use.

A piece of land and related property may be considered to be its highest and best use when it provides the maximum return to its owner or user. The return may be measured in monetary terms, or intangible and social ways, or a combination of such values. However, the value of a piece of land is not static and can change over time. The highest and best use of a property at any point in time is derived from four qualities as follows:

- Legally allowable under local laws and regulations
- Physically possible use of the subject land and building
- Financially feasible for the use of the subject land and building
- Maximum utility/profitability for use of the land and building

In today's struggling CRE market, the highest and best-use concept has been put to the test, with hundreds of office properties around the country ripe for changing from their former use. During

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the last 10 ten years, there have been two large changes in use for many CRE properties. The first is the conversion of former commercial sites such as gas stations, older urban office buildings and suburban strip retail centers into hi-rise and garden apartment projects. The other and more dramatic, highest, and best-use change is older suburban mall properties that are being converted into industrial, office, hotel, medical office, food courts, fitness centers and bowling alleys. Today, there is a new highest and best-use conversion, office buildings in urban cities to apartments or in some cases hotels.

The major reasons for the highest and best-use conversions in the office sector are the tremendous loss of value of many older and physically obsolete buildings, a change in tenant demand for these properties and potentially higher rents for the conversion of these office buildings into multifamily rentals. Since most of these properties are located in dense urban cities, the change in demand is primarily for apartments and to a lesser extent, hotels. However, the physical process of a conversion to apartments is fraught with risk, can be very expensive and physically challenging and maybe only 10.0% of office buildings may qualify for this highest and best use change.

Most older office buildings that are candidates for conversion have large floor plates of 10,000 to 25,000 square feet. This requires a new central core, typically around the elevator



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shafts to provide light and windows for the apartment units on the interior of the building. Many local building codes require that apartments have windows for safety reasons. Each floor will need additional HVAC and plumbing for each unit, which is an expensive endeavor. It can also be difficult to redesign existing office spaces with residential-type windows, common amenities and create a property that is aesthetically attractive. Outside of the physical difficulties of a conversion, the other major obstacle to these conversions is being able to purchase the existing and obsolete office building at a deep discount and close to the value of just the land for the financial economics to work. Most of the buildings that are viable for this conversion will be distressed assets, either in default or foreclosure and the buyer will need to acquire the asset for no more than one and a half times the land value. This value will provide the buyer with a low enough basis to take the physical conversion, lease-up and financing risks of the project. The concept of the highest and best use is the economic foundation of the CRE investment business. Seeking investments that can be converted to a higher and better use is another way to create value and profits in today's competitive real estate environment.

Strategy and Insight for the Commercial Real Estate Industry

A Publication of Paramount Capital Corporation

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

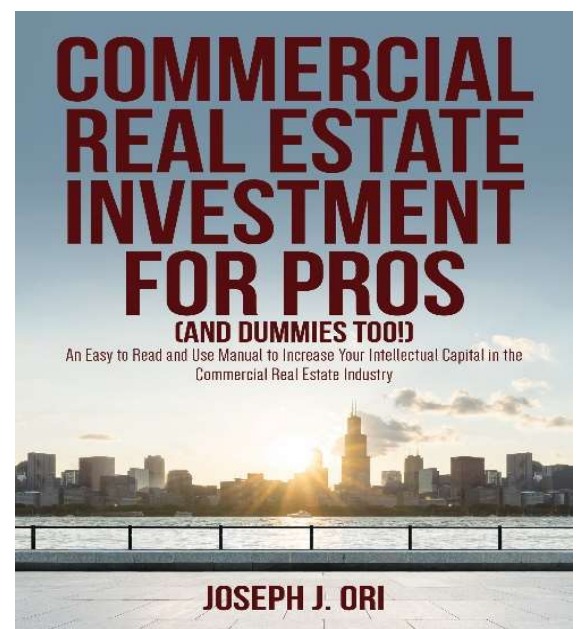
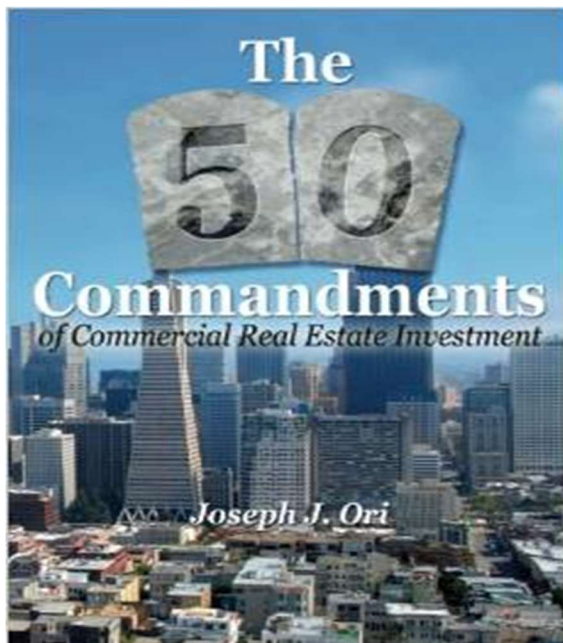
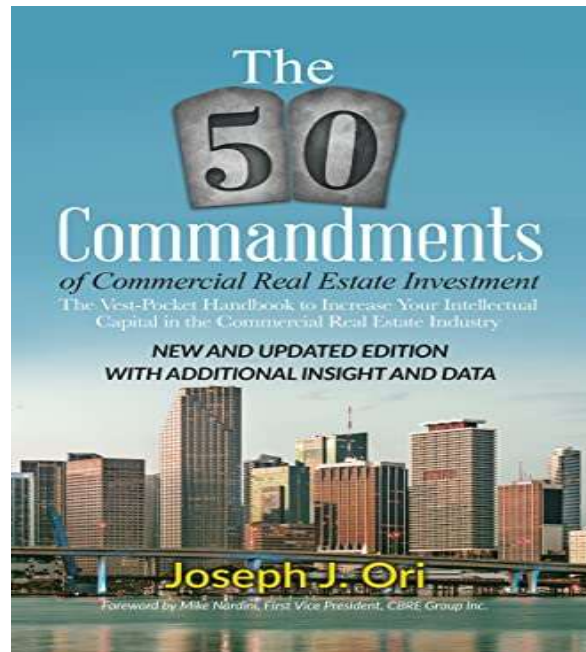
reading for the experienced real estate pro and also understandable to the real estate novice or someone new to the industry.

View of the Market

Volume XV/Issue
11/November
2023

Strategy and Insight for the Commercial Real Estate Industry

A Publication of Paramount Capital Corporation



View of the Market

Volume XV/Issue
11/November
2023

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%-5.02%+	30	10	80%

Commercial Loan Index Rates	
Prime Rate	8.50%
30-Day SOFR (secured overnight funding rate)	5.32%
1 Year Swap	5.64%
10 Year Swap	3.87%
5 Year Treasury	4.51%
10 Year Treasury	4.54%
Federal Funds Rate	5.25%



Strategy and Insight for the Commercial Real Estate Industry

A Publication of Paramount Capital Corporation

Short-term interest rates moderated somewhat with the 30-day SOFR rate at 5.32%. The Federal Reserve met from October 31st to November 1st and decided not to increase the federal funds rate. The Fed meets for the last time in 2023 on December 12th and 13th. It appears that there may be one more rate increase of .25% and then the Fed will begin to lower rates in 2024. 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.

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
Realty Income REIT	Spirit Realty Capital REIT	Realty Income Will Acquire Spirit Realty in a Merger	\$9.3B	Merger of both REITs that own net lease assets.
Parks Hospitality Holdings	Sunstone Hotel Investors, Inc.	1,060 Room Boston Park Plaza Hotel, Boston, MA	\$370M	Purchase and reflagging of the hotel to Hilton.
Prologis REIT	Creation and Cross-Harbor Capital Partners	Airport Logistics Center, Goodyear, AZ	\$184M	A 2.7 million square foot industrial park.
MG Properties Group	Walker & Dunlop, Inc.	Waterleaf, Vista, CA	\$174M	A 456-unit apartment complex.

View of the Market

Volume XV/Issue
11/November
2023

Strategy and Insight for the Commercial Real Estate Industry

A Publication of Paramount Capital Corporation

Kairoi Residential	Confluence Cos.	Zia Sunnyside, Denver, CO	\$161M	A 434-unit apartment complex.
Blue Ridge Industrial	Dogwood Industrial Properties	Industrial Portfolio, North Carolina	\$105M	A 28-property industrial portfolio with 1.4 million square feet.
Goldelm	Passco Companies LLC	ParkCrest Landings, Bradenton, FL	\$102M	A 400-unit apartment complex.
Eagle Property Capital and Promecap	Providence Real Estate	The Boot Ranch, Palm Harbor, FL	\$81M	A 432-unit apartment complex built in 1996.
Journey Capital	Northland	Caribbean Isle, Melbourne, FL	\$71M	A 327-unit apartment complex built in 1990.
Apples Hospitality REIT	MCR	Residence Inn, Seattle, WA	\$55M	A 146-room hotel.

Strategy and Insight for the Commercial Real Estate Industry

A Publication of Paramount Capital Corporation

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. People as Resources

People are a resource and not just a cost. The most enlightened managers have started to understand what could be realized by managing people toward a desired end or goal. Management is so much more than exercising rank and privilege: it's so much more than "making deals." Management affects people and their lives, both in business and in many other aspects as well.

II. Making Manual Work Productive

Knowledge work includes manual operations that require industrial engineering. The first step in making the manual worker productive is to look at the task and to analyze its constituent motions. The next step is to record each motion, the physical effort it takes and the time it takes. Then motions that are not needed can be eliminated. Then each of the motions that remain as essential to obtaining the finished product is set up so as to be done the simplest way, the easiest way. Finally, the tools needed to do motions are redesigned.

III. Productivity of Service Work

Raising the productivity of service work is the first social responsibility of management. Real incomes cannot for any length of time be higher than productivity. Set annual targets for raising

Strategy and Insight for the Commercial Real Estate Industry

A Publication of Paramount Capital Corporation

the productivity of your service staff. Reward those who are successful in meeting these new targets.

IV. Knowledge-Worker Productivity

Knowledge-worker productivity requires that the knowledge worker to be both seen and treated as an asset rather than a cost. Work on the productivity of the knowledge worker has barely begun. Six factors determine knowledge-worker productivity. 1. Knowledge-worker productivity demands we ask the question: “What is the Task?” 2. It demands that we impose the responsibility for their productivity on the individual knowledge workers themselves. 3. Continuing innovation has to be part of the work, the task and the responsibility of knowledge workers. 4. Knowledge work requires continuous learning on the part of the knowledge worker. 5. Productivity of the knowledge worker is not, at least primarily, a matter of the quantity of output. Quality is at least as important. 6. Finally, knowledge-worker productivity requires that the knowledge-worker be both seen and treated as an “asset” rather than a “cost.”

View of the Market

Volume XV/Issue
11/November
2023

Strategy and Insight for the Commercial Real Estate Industry

REIT Statistics

Current REIT statistics for 9/20/23 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.

<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>(Q3-23)</i>		
9/2023	-5.17%	-5.61%	-4.15%	13.07%	27.11%
1-Year	-0.89%	-1.71%	-18.01%	21.62%	26.11%
5-Year	2.37%	2.79%	3.39%	9.92%	11.41%
10-Year	5.99%	6.17%	8.58%	11.91%	14.52%
20-Year	7.39%	7.90%	10.16%	9.72%	10.52%
Market Capitalization	\$1.17T	\$1.11T	\$312B	NA	NA
Dividend Yield	4.82%	4.44%	NA	1.57%	NA

Strategy and Insight for the Commercial Real Estate Industry

A Publication of Paramount Capital Corporation

REIT Review

Summary

This REIT valuation is on Kite Realty Group Trust (“KRG”), a publicly-traded REIT that is engaged in the ownership, operation, acquisition, development and redevelopment of high-quality open-air shopping centers and mixed-use properties. KRG owns 180 properties, with 28 million square feet and are located primarily in the Sunbelt and Northeast markets.

Property Developments and Tenants

As of September 30, 2023, KRG had four properties under development with 366,000 square feet and \$21 million in funds funded. The three largest tenants are; The TJX Companies, Inc. (2.5% of annual base rent), Best Buy Co., Inc. (2.0% of annual base rent) and Ross Stores, Inc. (1.9% of annual base rent).

Corporate Data

KRG is traded on the NYSE, is incorporated in Maryland, and is located in Indianapolis, IN. KRG has 219.3 million common shares outstanding and a market capitalization of approximately \$4,620 billion. KRG is an UpReit, and it owns or controls 98.5% of the interests in its operating partnership, Kite Realty Group, L.P. KRGs debt is rated BBB by Fitch Ratings.

Management

John A. Kite, 57, Chairman and CEO

John A. Kite is the Chairman and Chief Executive Officer of Kite Realty Group Trust. Mr. Kite is responsible for the strategic direction and operating results of the company. He serves as the head of the company’s capital allocation committee, which is responsible for major capital transactions. Prior to becoming Chief Executive Officer of Kite Realty Group upon its initial public offering in August 2004, Mr. Kite was President of Kite Companies from 1997–2004. In 1994, Mr. Kite was named President of KMI Realty Advisors, an affiliate of the Kite Companies. KMI Realty Advisors is a full-service, SEC-registered real estate advisory firm. Mr. Kite joined the Kite organization as Chief Financial Officer of Kite Development in 1990. Mr. Kite was a

View of the Market

Volume XV/Issue
11/November
2023

Strategy and Insight for the Commercial Real Estate Industry

A Publication of Paramount Capital Corporation

Business Development Officer in the Commercial Lending Department of Harris Trust and Savings Bank in Chicago, IL from 1987-1990. Mr. Kite holds a BA in Economics from DePauw University.

Ownership

Top Institutional Holders	Shares (000's)	%
Blackrock, Inc.	33,424	15.24
The Vanguard Group, Inc.	32,093	14.63
State Street Corporation	13,340	6.08
JP Morgan Chase and Company	13,107	5.97
Macquarie Group, Ltd.	10,699	4.88

Ownership Breakdown	
% Of Shares Held by All Insiders and 5% Owners	.84
% Of Shares Held by Institutional & Mutual Fund Owners	99.51
Number of Institutions Holding Shares	452

All amounts above per Yahoo Finance

View of the Market

Volume XV/Issue
11/November
2023

Strategy and Insight for the Commercial Real Estate Industry

A Publication of Paramount Capital Corporation

Financial Analysis and Valuation

Select financial data for KRG per the Q3-23 10Q and supplemental information.

(In millions where applicable)

Financial Data	Amounts
Real Estate Assets, Gross	\$7,708
Total Assets	\$7,052
Property Debt (at weighted average interest rates of 4.35%)	\$2,868
Stockholders' Equity	\$3,637
Revenue	\$622
Net Income (Loss)	\$39
Cash Flow from Operations	\$291
Unsecured Credit Facility (1.1B with \$0B used)	\$1,100
Market Capitalization	\$4,620
Property Debt to:	
Gross Real Estate Assets	37%
Market Capitalization	62%
Enterprise Value	38%
Dividend and Yield (\$1.00/sh.)	4.84%
Shares Sold Short (in millions per Yahoo Finance)	5,220

View of the Market

Volume XV/Issue
11/November
2023

Strategy and Insight for the Commercial Real Estate Industry

A Publication of Paramount Capital Corporation

Valuation Methodology	
Q3-23 Real Estate Revenue	\$622
Q3-23 Real Estate Operating Expenses (excluding depreciation, amortization, interest expense, impairment charges plus G&A expenses)	<u>\$203</u>
Q3-23 Net Operating Income	\$419
Annualized Proforma Net Operating Income at 103%	\$575
Projected Average Cap Rate	<u>7.0%</u>
Projected Value of Real Estate Assets	\$8,214
Add: Net Operating Working Capital (at book value)	<u>\$176</u>
Total Projected Value of the Assets of the Company	\$8,390
Less: Total Debt Per Above	<u>(\$2,868)</u>
Projected Net Asset Value of the Company	<u>\$5,522</u>
Common Shares Outstanding, 219.3M	
Projected NAV Per Share	\$25
Market Price Per Share on 11/15/23	\$20
Premium (Discount) to NAV	(20%)

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 KRG for the years 2018 through Q3-23 are shown in the table below.

(Millions except dividend and per share amounts)	2018	2019	2020	2021	2022	Q3-23
Gross Real Estate Assets	\$3,641	\$3,087	\$3,143	\$7,592	\$7,732	\$7,708
Property Debt	\$1,543	\$1,146	\$1,170	\$3,150	\$3,010	\$2,868
Revenues	\$354	\$315	\$266	\$373	\$801	\$622
Net Income (Loss)	(\$46)	(\$.5)	(\$16)	(\$80)	(\$12)	\$39
Funds from Operations (FFO)	\$167	\$128	\$105	\$86	\$425	\$337
Return on Invested Capital (1)	7.4%	8.0%	6.0%	2.3%	7.1%	NA
Dividend Coverage (2)	1.53	.92	2.69	1.46	2.33	2.06
Dividends Paid Per Share	\$1.27	\$1.3647	\$1.4495	\$.68	\$1.8201	\$.96

- (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 \$.24 per quarter.

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

KRG Total Return	9/23	1-Yr	3-yr	5-Yr
	-5.10%	30.26%	27.75%	11.07%

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 KRG is \$25/sh., compared to a market price of \$20/sh. Current average cap rates for retail properties per our industry experience and CBRE's Cap Rate Survey are in the 5.0% to 9.0% range, depending on the location, tenancy, and sales per square foot of the anchor tenants. We have used an average cap rate of 7.0% due to KRGs diversified portfolio of shopping center assets.

Strengths:

- An attractive dividend yield of 4.84%.
- A low debt to enterprise value of 38%.
- The stock is trading at a 20% discount to our NAV.

Concerns:

- REIT prices will decline if interest rates increase.

Recommendation:

KRG is trading at a discount of 20% to our NAV per share and we are recommending the purchase of the stock.