Strategy and Insight for the Commercial Real Estate Industry

VIEW OF THE MARKET

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REAL ESTATE FOCUS

What is the NOI?

The most important metric in valuing a CRE property is the net operating income (NOI). It is used as the basis for CRE valuation whether it is an acquisition, sale, or appraisal. A property's NOI is calculated as follows:

Gross Potential Rent (annual rent for all signed leases plus vacant space at the market rent)
Plus: Other income (tenant reimbursements, parking, percentage rent, etc.)
Less: Vacancy (as a percent of the gross potential rent)
Equals: Effective Gross Income
Less: Operating Expenses (excluding tenant improvements, leasing commissions, capital improvements and debt payments)
Equals: **Net Operating Income**

The NOI is important because it is the cash flow metric used to value a property. For example, if the NOI in an acquisition is $1,000,000 and the purchase price is $15,000,000, then the cap rate is 6.67% ($1M/$15M). NOI is also important because it represents the initial cash flow from the property in which tenant improvements, leasing commissions, capital improvements and debt service (annual principal and interest on the debt) are paid. Many lenders also use NOI to value a property for loan purposes and a loan yield. The loan yield is the lender's NOI divided by the loan amount. Most lenders seek a loan yield of at least 9.0%. Therefore, calculating and using the appropriate NOI is critical to making smart acquisition decisions. After all, most of the profit made on a CRE deal is when the property is bought, not when it's sold.

In all real estate acquisitions, there are multiple NOI's to review and calculate and using the proper one is vital to making a good deal. There are typically four different NOI's in a CRE acquisition transaction. They are the seller's actual NOI, the seller/broker proforma NOI, the buyer's adjusted actual NOI and the buyer's proforma NOI. Since there are four NOI's, the question is, which one should be used? It depends if one is on the sell side or buy side of the deal. If on the seller side, the seller/broker NOI that is shown in the sales package is promoted and pushed by the seller/broker team as the most realistic for the property because it is usually an inflated number and used to validate the seller's high asking price. If on the buyer's side, the preferred amount is the buyer's proforma NOI and is almost always much lower than the seller/broker number. The buyer's NOI is usually lower because of more conservative underwriting assumptions, like lower rent adjustments, higher vacancy and increased operating expenses which are typically discovered during the due diligence and underwriting process. The purchaser of a property will operate and manage the property differently than the seller and its NOI and operating metrics will usually reflect this.

Below, we will review an example of a real acquisition transaction to show the contrasting NOI's for a 250-unit apartment complex located in Dallas, TX and placed up for sale earlier this year for $30 million. The property is a Class B apartment complex on 12.5 acres and is 95% leased. The sales package received from a national brokerage firm included the 2022 actual NOI and the 2023 proforma NOI of $1,500,000 and $1,800,000, respectively. Our buy-side analysis of the deal produced two different NOI's as follows, an adjusted actual 2022 NOI of $1,450,000 and a 2023 proforma NOI of $1,600,000. Our buy-side adjustments included higher vacancy for leases not signed, increased management fees and higher repair and maintenance expenses. These are typical adjustments made by purchasers during the deal underwriting process. A table of the NOI's and cap rates is as follows:

	Sell Side		**Buy Side**	
	Actual 2022 NOI	Seller/Broker Proforma 2023 NOI	Purchaser Adjusted 2022 NOI	Purchaser Proforma 2023 NOI
NOI	$1,500,000	$1,800,000	$1,450,000	$1,6000,000
Asking Price	30,000,000	$30,000,000	$30,000,000	$30,000,000
Cap Rate	5.0%	6.0%	4.8%	5.3%

Based upon the above table, what NOI and cap rate should the buyer use? The purchase offer price and deal analysis should be based on the buyer's proforma NOI of $1,600,000. With a proforma NOI of $1,600,000, the final offer for the property acceptable to the buyer would be at a 6.5% cap rate or a price of $24,600,000 million versus the asking price of $30 million.

An Update on the Apartment Market

According to Yardi Matrix, a CRE analytics firm ass of January 2023, the national apartment market is cooling with flat or declining rents, higher mortgage rates and a wave of proposed rent control measures. The average one-bedroom rent was unchanged at $1,701 from December and the year-over-year growth shows a decline of 5.5%. Year-over-year rent growth for some of the hottest apartment markets are shown in the chart below.

City	YoY Rent Growth
1. Indianapolis	10.2%
2. San Jose	8.0%
3. Miami	7.5%
4. Chicago	7.0%
5. Dallas	7.0%
6. Tampa	4.7%
7. Phoenix	1.0%
8. Las Vegas	.5%

Despite the strong performance of the multifamily market over the last seven years, there are many concerns due to higher interest rates, less demand, higher operating costs and rent control. The basic operating and capital expenses are rising for big items and certain markets by 10.0% per year and this is negatively affecting the property operating income and cash flow. For example, insurance costs for coastal properties have skyrocketed due to Hurricane Ian in Florida.

In addition to higher mortgage rates, property owners are faced with surging hedging costs for floating-rate debt loans priced at spreads over the secured overnight funding rate (SOFR). Buying an interest cap, collar or a swap typically would cost about .25%-.50%, of the loan amount, depending on the specific product and structure. However, during the last year, these fees and costs have ballooned to about 2.0%-5.0% of the loan and this has created a huge financing problem for property buyers and owners. Most sponsors have to either take out a short-term bank loan or invest additional equity to cover these additional loan costs, both of which are extremely difficult in this environment.

Another significant threat to the apartment sector is the expansion of rent control. Before the November 2022 mid-term elections, three states had statewide rent control, New York, California, and Oregon and one city, St. Paul, MN had rent control. In the mid-terms, voters approved rent control in Portland, ME, and Orange County, FL and many other states are considering new rent control measures, including IL, MA, CT, and others and many of these states will have rent control on the ballot again in 2024.

Five CRE Myths Exposed

1. Most office buildings will become obsolete as most workers will work from home

There are 14 billion square feet of office space in the U. S. and the national vacancy rate per Yardi Matrix, a CRE analytics firm is 16%. There are also 135 million square feet of new office construction in the country. The office market is very large and vital to the operation, growth and vitality of millions of companies and the economy. The office market is not going away and demand for space in the next five years will be very strong. The trend of working from home has been a fixture of the U.S. economy for the last 30 years with telecommuting, hoteling, and work-from-home on Friday programs. The primary office industry that is promoting work from home is the technology sector, but it represents only about 20% of the total office market or 2.8 billion square feet. Even if 10% or 280 million square feet of all the tech space is not needed because of work-from-home programs, this is still only 2.0% of the total market.

Most employees want to be in the office and be close to their boss and senior executives who determine their compensation. They also want to find a mentor, who will want them on their team and help guide their career path. If an employee is not in the office, then they are not enjoying the camaraderie of the office mates, will have a difficult time finding a mentor, receive lower compensation, earn fewer promotions and compensation increase and receive little or no training from experienced senior personnel.

The office markets in the Gateway cities of Los Angeles, San Francisco, Oakland, Seattle, Portland, New York, Atlanta, Chicago, and Baltimore are suffering the most with high vacancies and utilization rates of less than 50%. This is due to their high crime rates, rampant homelessness, high taxes, and poor governance. The office markets in the high-growth Sunbelt states are outperforming with high occupancies, increased rental rates and office utilization rates over 85%. Once the crime and homelessness situations are these key cities is brought down, the office markets will flourish.

2. LEED-certified buildings are in great demand and command higher effective rents

Leadership in Energy and Environmental Design (LEED) is one of the most popular green building certification programs used worldwide. The LEED certification was developed by the non-profit U.S. Green Building Council (USGBC) and includes a set of rating systems for the design, construction, operation, and maintenance of green office buildings that aim to help building owners and operators be environmentally responsible and use resources efficiently. Being environmentally conscious with a LEED-certified building or leasing space in one is commendable and should be applauded. However, there is no difference in rents as compared to a similar building that is not LEED certified. A newly constructed LEED-certified building may have lower operating expenses due to the use of more energy-efficient operations and systems but will not command a higher rent per square foot than a similar non-LEED building.

3. The industrial market will continue to boom with ever-increasing demand and rents

The hottest sector of the CRE industry during the last several years has been the industrial market. There is 16 billion square feet of industrial space in the U.S. with a minimal vacancy rate of 3% per Cushman and Wakefield, a CRE brokerage firm. There is also over 600 million square feet of industrial space under construction, a historical high. Triple net rents increased substantially during the last few years with the national average at $8.36 per square foot and up 19% year over year. However, the industrial boom has slowed down tremendously since last fall due to higher inflation, less demand for goods, higher interest rates and higher unemployment. The industrial market is not infallible and like any booming investment, it will come back to reality, and this is what is currently happening. Rents will soften and decline by 10%-20%, and occupancy in the booming areas like the Inland Empire, Orange County, San Francisco and Miami will see the largest negative effects of this slowdown.

4. Shared office space arrangements like WeWork are the future of office demand

Share office space or executive suite arrangements have been around for a century. These businesses that rent a large block or floor of an office building and release it to small tenants as executive suites are and always will be a niche sector of the CRE office market. The amount of shared or flex space in the U.S. is less than .5% of the total office inventory of 14 billion square feet. Executive suites are important to the office market and serve a very small niche of start-up companies, consultants, executives in job transition and others seeking a cheaper way to have an office address, secretarial services, and meeting space. These companies can do very well in a growing economy like the present, but many will be in financial trouble or go out of business when the next recession hits. Their business model has large and long-term commitments for office space, which is leased to small tenants on a short-term basis. This is a well-known mismatch of assets and liabilities by borrowing long and investing short. This business model has very high operating leverage due to the large amount of fixed leased liabilities and is very vulnerable to an economic downturn.

5. Higher interest rates will not affect the CRE market

Higher interest rates are coming to the U.S. economy and will have a dramatic negative effect on the CRE industry. The CRE industry has enjoyed 13 years of ultra-low interest rates which have artificially increased asset prices and reduced cap rates.

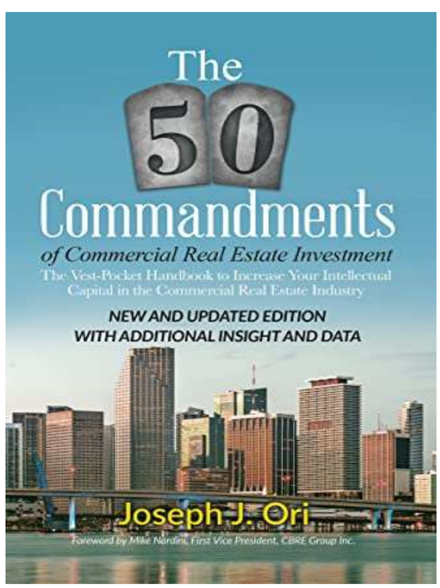
The federal funds rate is currently 4.5% and this is up from zero percent only eleven months ago. While short-term rates are controlled by the Federal Reserve, long-term rates are determined by the fixed-income market through investor expectations of risk and inflation. So far, the yield curve has inverted with the one-year Treasury bill at 4.88% and the 10-year and Treasury Note at 3.7%. It appears that long-term rates will continue to rise with the 10-year note at or above 4.5% by the end of this year. This is bad news for the CRE industry. CRE values have declined significantly during the last 12 months and will continue to do so in the next few years as rates continue to increase. There is also a large bid-ask spread for properties today and this has reduced transaction volumes by at least 70%.

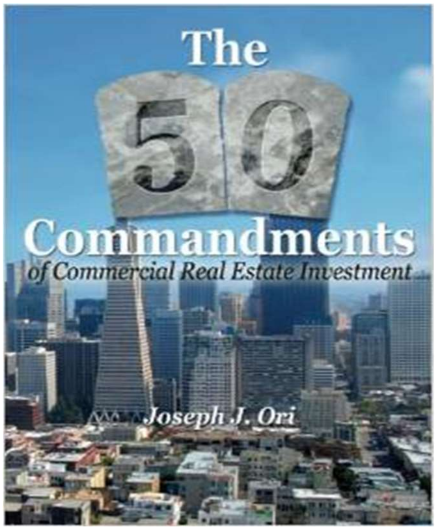
Get Your Copy of Three Great CRE Books by Our Editor, Joseph Ori

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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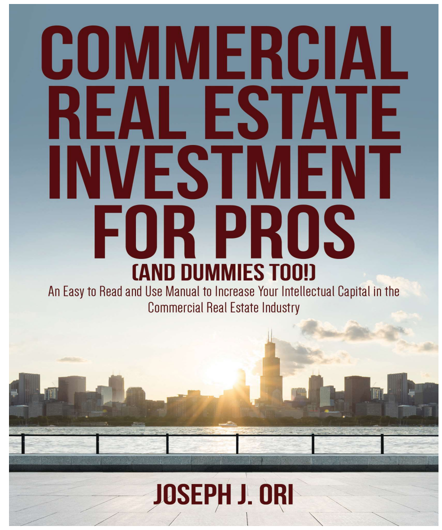
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An Easy to Read and Use Manual to Increase Your Intellectual Capital in the Commercial Real Estate Industry
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CRE Financing Rates

Loan Type	Mortgage Rate	Maximum Amortization	Term (years)	Maximum LTV
Permanent Loans	6.38%-9.75%+	30	10	75%
Conduit-CMBS	6.12%-7.36%+	30	10	75%
Bridge Loans	8.85%-17.85%+	Interest Only	1-3	90%
Construction Loans	9.24%-14.25%+	Interest Only	1-4	75%
Insurance Co. Loans	5.88%-7.89%+	30	10	70%
Fannie Mae/Freddie Mac	5.79%-5.83%+	30	10	80%

Commercial Loan Index Rates	
Prime Rate	7.75%
30 Day LIBOR	4.58%
90 Day LIBOR	4.84%
30 Day SOFR (secured overnight funding rate)	4.36%
1 Year Swap	5.22%
10 Year Swap	3.62%
5 Year Treasury	3.99%
10 Year Treasury	3.70%
Federal Funds Rate	4.50%

Short-term interest rates have remained elevated with the 30-day SOFR rate up to 4.36%. The 30-day LIBOR rate is also up to 4.58% from .51% in April 2022 and longer-term treasury rates have increased somewhat with the 10-Year treasury rate up to 3.70%. This is due to the Fed raising the federal funds rate by .25% on 2/1/23. The yield curve is becoming more inverted as the Fed continues to raise short-term interest rates. 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.

CRE Deal Focus

CRE Deals of the Month

Purchaser/ Sponsor	Seller	Property/ Deal	Price	Description
Related Cos.	Wentworth Property Co.	18-property self-storage portfolio	$267M	An 18-property self-storage portfolio with 1.3 million square feet and 9,600 storage units.
Spear Street Capital	State Street	Perimeter Summit Office Buildings, Atlanta, GA	$247M	Three office buildings with 1.25 million square feet.
J.P. Morgan Chase	MetLife Investment Management	Chase Bank Net Lease Portfolio, No and So, CA.	$138M	A portfolio of 22 net-leased bank sites.

Tishman Speyer	Green Cities Co.	The Eddy, Boston, MA	$135M	A 17-story, 259-unit high-rise apartment property that was built in 2016.
Bayshore Properties	The Connor Group	Stonebridge Apartments, Arlington Heights, IL	$131M	A 586-unit apartment property that was built in 1973.
Stonehenge NYC	UBS	River East, NY, NY	$115M	A 32-story, 196-unit apartment tower.
Avanath Capital Management	The Brodsky Organization	7 DeKalb Ave., Brooklyn, NY	$101M	An 18-story, 251-unit apartment tower.

Link Logistics	The Rockefeller Group	Industrial Building, Northampton, PA	$91M	A 453,600 square foot industrial property built in 2022.
MG Properties	The Bascom Group	Tribeca North Apartments, Las Vegas, NV	$81M	A 312-unit apartment complex.
Morgan Stanley	Pollack Financial Group	Medical Office Building, Menlo Park, CA	$68M	A 44,719 square foot medical building fully leased to Menlo Medical Clinic.

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. Human Factor in Management

The task of management is to make people capable of joint performance, to make their strengths effective and their weaknesses irrelevant. Management must be built on communications and on individual responsibility. Management must enable the enterprise and each of its members to grow and to develop as needs and opportunities change.

II. Failure of Central Planning

Any society in the era of new technology would perish miserably were it to run the economy by central planning. The new technology will greatly extend the management area; many people now considered rank and file will have to become capable of doing management work. The new technology will demand the utmost in decentralization.

III. Governance of the Corporation

What does capitalism mean when knowledge governs rather than money? We will have to redefine the purpose of the employing organization and of its management, to satisfy both the legal owners, such as shareholders and the owners of the human capital that gives the organization its wealth-producing power, that is, the knowledge workers. For increasingly the ability of organizations to survive will come to depend on their "comparative advantage" in making the knowledge worker productive.

IV. Defining Business Purpose and Mission

What is our business? Nothing may seem simpler or more obvious than to know what a company's business is. A business is not defined by the company's name, statutes, or article of incorporation. It is defined by the want the customer satisfies when she buys a product or a service. To satisfy the customer is the mission and purpose of every business. The question "What is our business?" can, therefore, be answered only by looking at the business from the outside, from the point of view of the customer and the market.

REIT Statistics

Current REIT statistics for 2022 per NAREIT and NCREIF are included in the table below. Please note the 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 (2022)*	*S&P 500*	*NASDAQ Composite*
2022	-25.10%	-24.95%	6.02%	**-18.11%**	-32.65%
1-Year	-25.10%	-24.95%	6.02%	**-18.11%**	-32.54%
5-Year	3.91%	4.43%	8.73%	9.42%	**9.67%**
10-Year	6.86%	7.10%	10.81%	12.56%	**14.43%**
20-Year	8.90%	9.42%	10.06%	9.80%	**10.84%**
Market Capitalization	$1.21T	$1.21T	$281B	NA	NA
Dividend Yield	4.37%	3.97%	NA	1.66%	NA

REIT Review

Summary

This REIT valuation is on the Brixmor Property Group, Inc. ("BRX"), a publicly-traded REIT that is engaged in the ownership, management, leasing, acquisition, disposition, and redevelopment of retail shopping centers located throughout the U.S. BRX owns or has interests in 378 retail centers with approximately 67 million square feet.

Property Information

As of Q3-22, the occupancy rate was 89.6% and the Q3 YoY increase in rental income was up 2.6%. The three largest tenants are TJX (3.3% of annual base rent), Kroger (2.4% of annual base rent) and Burlington (1.9% of annual base rent).

Corporate Data

BRX is traded on the NYSE, is incorporated in Maryland, and is located in New York, NY. BRX has 179.2 million common shares outstanding and a market capitalization of approximately $6.967 billion. BRX is rated Baa3 by Moody's, BBB by Fitch Ratings and BBB- by Standard and Poors. BRX owns a 100% managing ownership interest in its UpReit partnership, Brixmor Operating Partnership, L.P.

Management

James M. Taylor, Jr., 55, President, CEO and Director

Jim joined Brixmor Property Group in 2016, bringing over 20 years of extensive commercial real estate experience with him. His passion and leadership at Brixmor are grounded in a deep belief that retail shopping centers should do more than reflect the surrounding retail community: they should be an integral part of local daily life. "As we move forward, our mission as a Company is to own the center of the communities we serve. We want our centers to be relevant, we want them to be local and we want them to thrive." Jim is the Vice Chairman of ICSC and serves on the Executive Board for NAREIT. He is also a member of the Urban Land Institute ("ULI"). He received a B.S. and J.D. from the University of Virginia.

Ownership

Top Institutional Holders	Shares (000's)	%
Vanguard Group, Inc.	45,506	15.17
Blackrock, Inc.	35,059	11.69
Wellington Management Group, LLP	18,024	6.01

State Street Corporation	16,514	5.51
JP Morgan Chase & Company	12,445	4.14

Ownership Breakdown	
% Of Shares Held by All Insiders and 5% Owners	.66
% Of Shares Held by Institutional & Mutual Fund Owners	98.44
Number of Institutions Holding Shares	480

All amounts above per Yahoo Finance

Financial Analysis and Valuation

Select financial data for BRX per the Q3-22 10Q and supplemental information.

(In millions where applicable)

Financial Data	Amounts
Real Estate Assets, Gross	$10,873
Total Assets	$8,485
Property Debt (at a weighted average interest rate of approximately 3.70%)	$5,109
Stockholders' Equity	$2,828
Revenue	$909
Net Income (Loss)	$247
Cash Flow from Operations	$441
Unsecured Credit Facility ($1.25B with $200M used)	$1,050
Market Capitalization	$6,967
Property Debt to:	
Gross Real Estate Assets	47%

Market Capitalization	74%
Enterprise Value	42%
Dividend and Yield ($1.04/sh.)	4.56%
Shares Sold Short (in millions per Yahoo Finance)	4,760

Valuation Methodology	
Q3-22 Real Estate Revenue	$909
Q3-22 Real Estate Operating Expenses (excluding depreciation, amortization, interest expense, impairment charges plus G&A expenses)	318
Q3-22 Net Operating Income	$591
Annualized Proforma Net Operating Income at 103%	$812
Projected Average Cap Rate	7.0%
Projected Value of Real Estate Assets	$11,600
Add: Net Operating Working Capital (at book value and excluding goodwill)	7
Total Projected Value of the Assets of the Company	$11,607
Less: Total Debt Per Above	(5,109)
Projected Net Asset Value of the Company	$6.498
Common Shares Outstanding, 299.9M	
Projected NAV Per Share	**$22**
Market Price Per Share on 2/15/23	**$22**
Premium (Discount) to NAV	**0%**

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 BRX for the years 2017 through Q3-22 are shown in the table below:

(Millions except dividend and per share amounts)	2017	2018	2019	2020	2021	Q3-22
Gross Real Estate Assets	$10,921	$10,098	$10,123	$10,163	$10,428	$10,873
Property Debt	$5,676	$4,885	$4,861	$5,167	$5,164	$5,109
Revenues	$1,283	$1,234	$1,168	$1,053	$1,152	$909
Net Income (Loss)	$300	$366	$274	$121	$270	$247
Funds from Operations (FFO)	$638	$558	$572	$437	$522	$441
Return on Invested Capital (1)	9.0%	9.0%	9.4%	8.8%	9.5%	NA
Dividend Coverage (2)	2.00	1.67	1.71	2.57	2.03	2.03
Dividends Paid Per Share	$1.04	$1.10	$1.12	$.57	$.86	$1.04(3)

(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 $.26 per quarter.

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

BRX Total Return	12/22	1-Yr	3-yr	5-Yr
	-8.88%	-8.88%	8.29%	9.61%

As shown above, our net asset value per share for BRX is $22/sh., compared to a market price of $22/sh. Current average cap rates for retail properties per our industry experience and CBRE's Cap Rate Survey are in the 5.0% to 8.0% range, depending on the location, the tenancy of the properties and the sales volumes of the anchor tenants. We have used an average cap rate of 7.0% due to BRX's diversified portfolio of retail assets.