Strategy and Insight for the Commercial Real Estate Industry

VIEW OF THE MARKET

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REAL ESTATE FOCUS

The Death of the Office Market is Greatly Exaggerated Update

The U.S. office market is under attack by many news media outlets, pundits on Wall Street and uniformed financial bloggers. Some of the spurious headlines are that 25% of the office inventory will be obsolete by 2030, “the office apocalypse is upon us,” hundreds of office buildings will be closed and converted into apartments, Class B and C office buildings in urban markets will never be viable office properties again and most employees want to work from home instead of an office.

The death of the office market is greatly exaggerated, and these are some of the same people and firms who predicted back in 2018 that the retail market and malls, specifically, were obsolete. They proclaimed that no one would visit a mall again, everyone will shop online and many of the 800+ malls in the country will be boarded up and closed. The retail market did go through a gut-wrenching period of distress from 2015 to 2022 with tens of thousands of store closures, hundreds of retail company bankruptcies, and dozens of Class C mall closures. However, retailers and the retail market have bounced back strongly with higher sales and profits, higher rents and values, lower vacancies, and an overall healthier retail industry. The commercial real estate industry is very good at taking vacant and obsolete real estate assets and repurposing or renovating them to a higher and better use.

Today, there is substantial distress in the office market with loan defaults and foreclosures, but the majority of these issues are in the Gateway cities with high crime rates, rampant homelessness, poor quality of life and terrible governance. These cities include New York, Atlanta, Chicago, Los Angeles, Washington D.C., Philadelphia, San Francisco, Oakland, Seattle, and Portland. Office owners in these markets are suffering from low occupancies and office utilization and workers who refuse to work in the office in these urban wastelands. The primary reason these properties are hurting and the majority of workers do not want to go to the office is not because they prefer to work at home, but because they are afraid of the rampant crime, bodily harm, homelessness, riding a dangerous subway and are uncomfortable commuting to or spending eight to ten hours a day in these locales. I am located in the Bay area of Northern California and San Francisco; CA is the poster child for these ruinous policies. Visiting San Francisco these days is like being in an episode of the Walking Dead show. The other main issue facing these Gateway cities is the dramatic demographic shift of people and businesses out of these markets to suburban areas and other safer and more tax-friendly states. If companies and workers do not feel safe living in these urban cities from skyrocketing crime rates, they will not hesitate to leave and relocate, which damages the office and other real estate markets tremendously. This is what is occurring in the national office market.

The office utilization rate or the percentage of tenants actually going to the office daily in these Gateway cities as of March 1, 2023, per data from Kastle Systems, a company that provides access control systems to office users, was less than 51%, with New York at 45%, Los Angeles at 47.9%, Chicago at 50.4%, Washington D.C. at 47% and San Francisco at 43.5%. However, the utilization rates in the booming Sunbelt markets were over 60% with Austin at 68.1%, Houston at 61.8% and other cities much higher.

The national office market in 2023 is doing okay, especially given the turbulent economy and higher interest rates. Per Cushman & Wakefield's Q-4 2022, Office Report, the average asking rent was $37.38 psf and up 18.75% from $32 psf in 2019. The national vacancy rate was 18.2%, absorption was down YoY by 19 million square feet and there is 98.4 million square feet of new construction. However, if the Federal Reserve keeps increasing short-term interest rates, then the office market, especially in the Gateway cities will continue to deteriorate with much lower rents, higher vacancies, rising defaults, and foreclosures. Once the governance changes in these Gateway cities and the crime and homelessness are substantially reduced, the office markets will bounce back significantly. There may even be a profitable distressed investment strategy today by buying these half-leased office buildings at sixty cents on the dollar and waiting for the governance turnaround and selling them at ninety-plus cents on the dollar. In addition, many office buildings in these distressed markets will need an infusion of capital from mezzanine debt and/or preferred equity which could also be a highly profitable strategy.

An Update on the Retail Market

According to a retail report from Jones Lang LaSalle as of Q4-2022, the retail real estate market is doing very well with a national vacancy of only 4.2%, the average rent of $23.70 is up 4.0% YoY and net absorption of 76 million square feet of space during the year. The retail market is booming, especially after the gut-wrenching years of 2017 to 2021 which included thousands of store closures, dozens of bankrupt retail companies and a large increase in retail property defaults and foreclosures. The summary statistics from the JLL report are shown in the chart below.

Retail Type	Total Square Footage	Average Rent Q4-22	YoY Rent Growth
1. General Retail	6,363,000,000	$22.87	3.5%
2. Malls	906,000,000	$32.12	4.1%
3. Power Centers	800,000,000	$25.34	4.3%
4. Neighborhood Centers	2,970,000,000	$22.78	4.9%
5. Strip Centers	701,000,000	$21.61	4.7%
6. Other	105,000,000	$27.89	4.5%
Totals	11,845,000,000	$23.70	4.0%

The performance of the retail market during the last few years has been extraordinary and the turnaround has been very successful. Any investor who bought shopping centers and Class A/B malls at deep discounts and high cap rates that were in the double digits from 2018 to 2021 has profited handsomely today. However, with higher interest rates and inflation, the robust retail industry may slow down, but investors should still seek to acquire solid retail properties.

The Ten Scariest Terms in the CRE Industry

There are many positive words and terms of wisdom in the CRE industry like that was a great deal, great management equals great value, you make money when you buy not sell, I would rather buy a Class B property in an A location than a Class A property in a B location, we don't buy properties with negative leverage and I would rather own a good property at a great value, rather than a great property at a good value. However, there are also some very scary words and phrases in the CRE industry and below are ten of the worst.

1. Yes, we are buying this deal at a low cap rate, but; this is a one-of-a-kind asset that will always keep its value - This happens in every CRE cycle (apartments before the great recession and industrial properties from 2017 to 2022) with many overpriced institutional deals at sub 4.0% cap rates when the investor who won the overpriced bid for the property is trying to justify the outlandish price.

2. The major tenant in the building is rated BBB (investment grade) and its highly unlikely they will go out of business - The credit rating of many companies changes over time as their core business deteriorates, they make a bad acquisition, the new CEO is a poor manager, competitors enter the industry, or the company becomes highly leveraged. In corporate finance, there is a term called, “fallen angels” or companies that were once rated investment grade, but their business deteriorates, the credit rating drops to junk status, and they default on the rent.

3. This time it’s different - This occurs when CRE investors mistakenly think a technological, economic, demographic or property use change will create great real estate value. Most of the time these perceived changes are just fads and poor business models, like shared-office space will dominate office leasing (see the WeWork debacle), online shopping is going to “kill” malls and shopping centers (see Amazon stock price) and house flipping is a profitable business (see the disastrous forays in home flipping by Zillow and Opendoor).

4. Sometimes a higher and better use is to sell it to someone else - This is a Sam Zell quote and means, that if your property turns out to be a dog, sell it to someone else.

5. If you buy this property with a large vacancy, you will get the benefit of the new leasing – This is what the seller and broker will often tell the buyer when trying to sell a property with a large vacancy. Hey buyer, you can make a lot of money buying this property at an inflated price and leasing the vacant space. If that’s the case, why doesn’t the seller keep the property and get the cash flow and value increase from the new leases?

6. This portfolio is “Pigs and Queens” – The normal distribution for any large portfolio of CRE assets is 20% Class A (queens), 60% Class B and 20% Class C (pigs). Owners rarely sell a Class A or Class C portfolio because the Class A portfolio will be too expensive, and nobody wants the Class C properties. Therefore, sellers have to mix and match to get rid of the Class C assets. Whenever you are looking to buy a large CRE portfolio, make sure the cap rate is higher because of the Pigs.

7. This property type or market is dead and will never come back - This is heard a lot during times of financial distress or in a crash. Properties and markets always heal and turn around. Think of vacation homes in 2010, malls in 2018 and Class B/C office buildings today.

8. These empty stores will never get leased - This refers to large retail bankruptcies like RadioShack, Toys R Us, Sears, JC Penney, Gymboree, and many others, which placed thousands of empty stores on the market in the 2017 to 2022 period, but most locations were leased up within two years. The CRE industry is very adept at taking vacant stores and big boxes and recycling them into leased spaces and other uses.

9. This large CRE Excel worksheet with many spreadsheets is error-free - Every large and complicated Excel underwriting spreadsheet used to analyze CRE deals has at least one formula error.

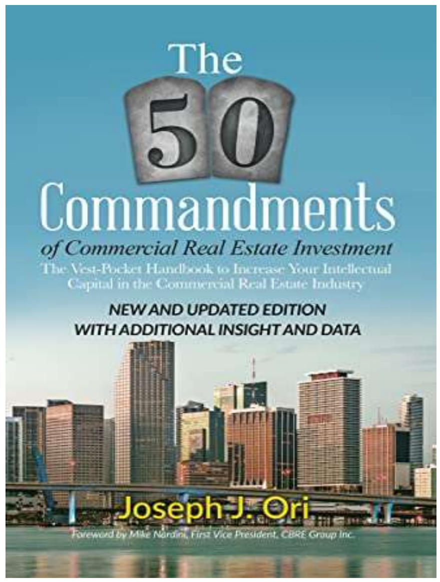
10. Financial engineering is more important than price - This is a Wall Street strategy that was very prevalent and led to the financial crisis in 2007 and includes using convoluted debt structures, high leverage, securitization, mezzanine, and equity structures to make a bad or overpriced deal look good. Think of "Lip Stick on a Pig."

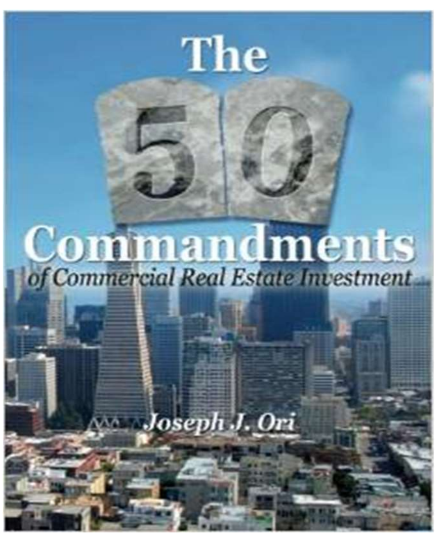
Get Your Copy of Three Great CRE Books by Our Editor, Joseph Ori

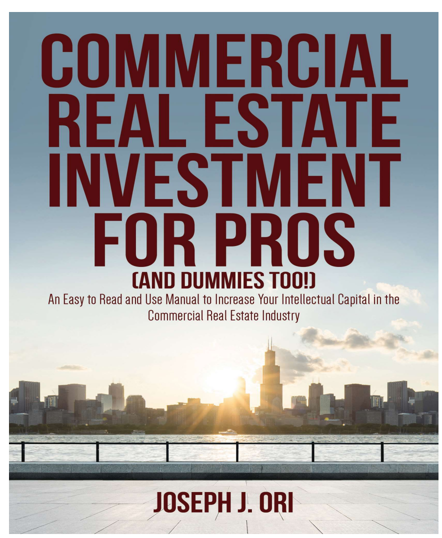
The editor of this newsletter, Joseph Ori, is pleased to offer his three CRE books for sale, "The Fifty Commandments of Commercial Real Estate Investment" Edition I and II and "Commercial Real Estate Investment for Pros (and Dummies Too!)." All books are available on Amazon and other book outlets in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







CRE Financing Rates

Loan Type	Mortgage Rate	Maximum Amortization	Term (years)	Maximum LTV
Permanent Loans	6.38%-9.75%+	30	10	75%
Conduit-CMBS	6.44%-7.79%+	30	10	75%
Bridge Loans	8.85%-17.85%+	Interest Only	1-3	90%
Construction Loans	9.25%-14.25%+	Interest Only	1-4	75%
Insurance Co. Loans	5.88%-7.89%+	30	10	70%
Fannie Mae/Freddie Mac	4.98%-5.79%+	30	10	80%

Commercial Loan Index Rates	
Prime Rate	7.75%
30 Day LIBOR	4.71%
90 Day LIBOR	5.00%
30 Day SOFR (secured overnight funding rate)	4.56%
1 Year Swap	5.57%
10 Year Swap	4.29%
5 Year Treasury	3.99%
10 Year Treasury	3.88%
Federal Funds Rate	4.50%

Short-term interest rates have remained elevated with the 30-day SOFR rate up to 4.56%. The 30-day LIBOR rate is also up to 4.71% from .51% in April 2022 and longer-term treasury rates have increased substantially with the 10-Year treasury rate up to 3.88%. This is due to the Fed raising the federal funds rate by .25% on 2/1/23 and further rate increases anticipated at the March 22nd Fed meeting. 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
Realty Income Corporation	EG Group	Single-Tenant Convenience Store Portfolio	$1.5B	A portfolio of 415 single-tenant convenience stores with 80% located in the Northeast.
Centerbridge Partners and GIC Real Estate	Shareholders	INDUS Realty Trust, Inc.	$868M	Acquisition of all the common stock of INDUS, an industrial REIT.
Hyundai Motor Group	Vanbarton	15 Laight St., NY, NY	$275M	A 108,000 square foot office building.

Amazon	Owens Corning Insulating Systems	Industrial Plant, Santa Clara, CA	$238M	An 877,424 square foot industrial property built in 1947 and the former home of Owens Corning Insulating.
Unknown	AIMCO	Park Merced Apartments Subordinate Loan, San Francisco, CA	$167M	AIMCO has sold its subordinate mortgage on the 3,221-unit Park Merced student housing property at about a 25%
Oxford Properties Group	Resilience	92 Crowley Dr., Marlborough, MA	$125M	A 120,000-square-foot life science building.
FPA Multifamily	C-III Capital Partners	Marina Shores, Virginia Beach, VA	$102M	A 392-unit apartment complex built in 1991.

Continental Realty Corp.	Switzenbaum & Associates	Sycamore at Tyvola, Charlotte, NC	$96M	A 288-unit apartment complex built in 2018.
Highpointe Communities	Trion Properties	The Metro and Andina, San Leandro and Hayward, CA	$86M	Two apartment complexes with 235 units.

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. Defining Business Purpose and Mission: The Customer

"Who is the customer?" is the first and crucial question in defining business purpose and business mission. It is not easy, let alone an obvious question. Most businesses have two customers. Both have to buy if there is to be a sale. The manufacturers of branded customer goods always have two customers at the very least: the housewife and the grocer. It does not do much good to have the housewife eager to buy if the grocer does not stock the brand.

II. The Change Leader

The most effective way to manage change successfully is to create it. One cannot manage change. One can only be ahead of it. In a period of upheavals, such as the one we are living in, change is the norm. In a period of rapid structural change, the only ones who survives are the change leaders. A change leader see change as an opportunity. A change leader looks for change, knows how to find the right changes, and knows how to make them effective both outside the organization and inside it.

III. Understanding What the Customer Buys

What does the customer consider value? The final question needed in order to come to grips with business purpose and business mission is: "What is value to the customer?" It may be the most important question. Yet it is the one least often asked. One reason is that managers are quite sure they know the answer. Value is what they, in their business, define as quality. But this is almost always the wrong definition. The customer never buys a product. By definition, the customer buys satisfaction of a want. He buys value.

IV. Test of Innovation

Measure innovations by what they contribute to the market and customer. The test of an innovation is whether it creates value. Innovation means the creation of new value and new satisfaction for the customer. Organizations measure innovations not by their scientific or technological importance but by what they contribute to market and customer.

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*
1/2023	10.30%	10.07%	6.02%	6.28%	**10.72%**
1-Year	-10.49%	-10.27%	6.02%	**-8.22%**	-17.95%
5-Year	6.66%	7.09%	8.73%	9.54%	**10.34%**
10-Year	7.46%	7.74%	10.81%	12.68%	**15.14%**
20-Year	9.59%	10.10%	10.06%	10.28%	**11.47%**
Market Capitalization	$1.40T	$1.33T	$281B	NA	NA
Dividend Yield	3.96%	3.61%	NA	1.57%	NA

REIT Review

Summary

This REIT valuation is on the Mid-America Apartment Communities, Inc. (“MAA”), a publicly-traded REIT that is engaged in the ownership, operation, acquisition and development of apartment communities located in the Southeast, Southwest and Mid-Atlantic regions of the U.S. MAA owns or has interests in 297 apartment communities with 99,676 units.

Property Information

As of December 31, 2022, the occupancy rate was 95.3% and the YoY increase in rental income was up 13.5%.

Corporate Data

MAA is traded on the NYSE, is incorporated in Maryland, and is located in New York, NY. MAA has 116.6 million common shares outstanding and a market capitalization of approximately $6.967 billion. MAA is rated A3 by Moody’s. MAA owns a 97.3% managing ownership interest in its UpReit partnership, Mid-America Apartments, L.P.

Developments

As of 12/31/22, MAA has six apartment properties under development with 2,310 units and a total cost of $728.7 million, with $291.7 million incurred to date.

Management

H. Eric Bolton, Jr., 65, Chairman and CEO

Mr. Bolton has served as our Chief Executive Officer since October 2001, and he became Chairman of the Board of Directors in September 2002. Mr. Bolton joined MAA in 1994 as Vice President of Development, was named Chief Operating Officer in February 1996 and was subsequently promoted to President in December 1996. Prior to joining MAA, Mr. Bolton served as Executive Vice President and Chief Financial Officer of Trammell Crow Realty Advisors, for which he worked for more than five years. Prior to that, Mr. Bolton worked in the commercial banking industry for seven years. Mr. Bolton currently serves on the board of directors for EastGroup Properties.

Ownership

Top Institutional Holders	Shares (000’s)	%
Vanguard Group, Inc.	19,175	16.45

Blackrock, Inc.	11,250	9.65
Cohen & Steers, Inc.	9,803	8.41
State Street Corporation	7,624	6.54
FMR LLC	4,714	4.04

Ownership Breakdown	
% Of Shares Held by All Insiders and 5% Owners	.66
% Of Shares Held by Institutional & Mutual Fund Owners	96.95
Number of Institutions Holding Shares	951

All amounts above per Yahoo Finance

Financial Analysis and Valuation

Select financial data for MAA per the 2022 10K and supplemental information.

(In millions where applicable)

Financial Data	Amounts
Real Estate Assets, Gross	$15,182
Total Assets	$11,241
Property Debt (at a weighted average interest rate of approximately 3.4 %)	$4,413
Stockholders' Equity	$6,189
Revenue	$2,019
Net Income (Loss)	$633
Cash Flow from Operations	$1,058
Unsecured Credit Facility ($1.25B with $0 used)	$1,250
Market Capitalization	$18,190

Property Debt to:	
Gross Real Estate Assets	29%
Market Capitalization	24%
Enterprise Value	19%
Dividend and Yield ($5.60/sh.)	3.59%
Shares Sold Short (in millions per Yahoo Finance)	1,850

Valuation Methodology	
2022 Real Estate Revenue	$2,019
2022 Real Estate Operating Expenses (excluding depreciation, amortization, interest expense, impairment charges plus G&A expenses)	846
2022 Net Operating Income	$1,173
Annualized Proforma Net Operating Income at 103%	$1,208
Projected Average Cap Rate	6.0%
Projected Value of Real Estate Assets	$20,133
Add: Net Operating Working Capital (at book value and excluding goodwill)	(360)
Developments and Capital Improvements in Process (at book value)	332
Undeveloped Land (at book value)	64
Investment in Joint Venture (at 2x book value)	84
Total Projected Value of the Assets of the Company	$20,253
Less: Total Debt Per Above	(4,413)
Preferred stock (at liquidation value of $50/share)	(43)

Projected Net Asset Value of the Company	$15,797
Common Shares Outstanding, 116.6M	
Projected NAV Per Share	**$135**
Market Price Per Share on 3/15/23	**$151**
Premium (Discount) to NAV	**12%**

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 MAA for the years 2017 through 2022 are shown in the table below:

(Millions except dividend and per share amounts)	2017	2018	2019	2020	2021	2022
Gross Real Estate Assets	$13,234	$13,598	$13,864	$14,277	$14,680	$15,182
Property Debt	$4,501	$4,528	$4,454	$4,562	$4,516	$4,413
Revenues	$1,528	$1,571	$1,641	$1,677	$1,778	$2,019
Net Income (Loss)	$324	$219	$350	$251	$530	$633
Funds from Operations (FFO)	$699	$712	$773	$761	$853	$972
Return on Invested Capital (1)	7.3%	8.3%	8.9%	9.2%	9.8%	11.4%
Dividend Coverage (2)	1.69	1.62	1.69	1.59	1.75	1.75
Dividends Paid Per Share	$3.48	$3.69	$3.94	$4.00	$4.675	$5.60(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 $1.40 per quarter.

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

MAA Total Return	1/23	1-Yr	3-yr	5-Yr
	7.12%	-16.88%	9.82%	15.38%

As shown above, our net asset value per share for MAA is $135/sh., compared to a market price of $151/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, age, and quality of the property. We have used an average cap rate of 6.0% due to MAA's diversified portfolio of apartment assets.

Valuation Analysis

MAA's strengths, concerns and recommendations are as follows:

Strengths:

- An attractive dividend yield of 3.59%.
- An investment grade credit rating.
- A very low debt to enterprise value of 19%.
- MAA has a diversified national portfolio of apartment assets.

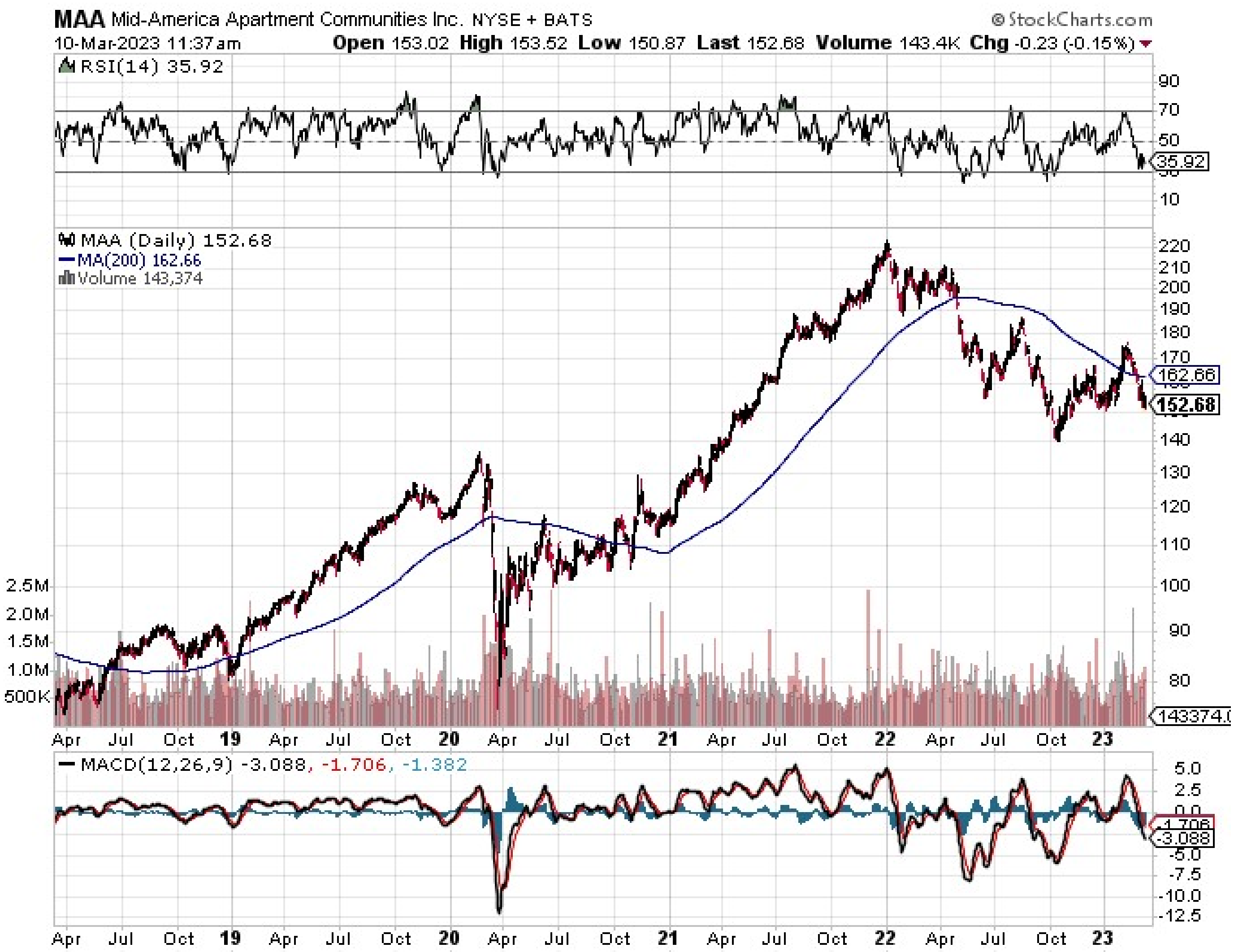
Concerns:

- REIT prices will decline if interest rates increase.
- MAA is trading at a 12% premium to our NAV

Recommendation:

MAA is trading at a premium to our NAV, and therefore, we are not recommending the purchase of the stock.

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



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

1. WP Carey, November 15, 2020
2. Equity Residential, December 15, 2020
3. Douglas Emmett, Inc., January 15, 2021
4. Boston Properties, Inc., February 15, 2021
5. Spirit Realty Capital, Inc., March 15, 2021
6. Duke Realty Corporation, April 15, 2021
7. Essex Property Trust, Inc., May 15, 2021
8. AvalonBay Communities, Inc., June 15, 2021
9. Brixmor Property Group, Inc., July 15, 2021

10. Cousins Properties, Inc., August 15, 2021
11. Mid-America Apartments, Inc., September 15, 2021
12. VEREIT, Inc., October 15, 2021
13. Spirit Realty Capital, Inc, November 15, 2021
14. First Industrial Realty Trust, Inc., December 15, 2021
15. Camden Property Trust, Inc., January 15, 2022
16. Healthcare Trust of America, Inc., February 15, 2022
18. Simon Property Group, Inc., March 15, 2022
19. Brandywine Realty Trust, April 15, 2022
21. Rexford Industrial Realty, Inc., May 15, 2022
22. Host Hotels & Resorts, June 15, 2022
23. The Macerich Company, July 15, 2022
24. Hudson Pacific Properties, Inc., August 15, 2022
25. Kilroy Realty Corporation, September 15, 2022
26. Realty Income Corporation, October 15, 2022
27. Federal Realty Trust, November 15, 2022

28. Equity Residential, December 15, 2022
29. STAG Industrial, January 15, 2023
30. Brixmor Property Group, Inc., February 15, 2023

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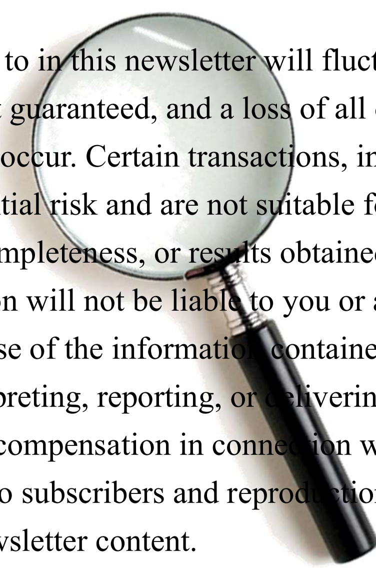

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