

# View of the Market

Volume XV/Issue  
8/ August 2023

Strategy and Insight for the Commercial Real Estate Industry

A Publication of Paramount Capital Corporation

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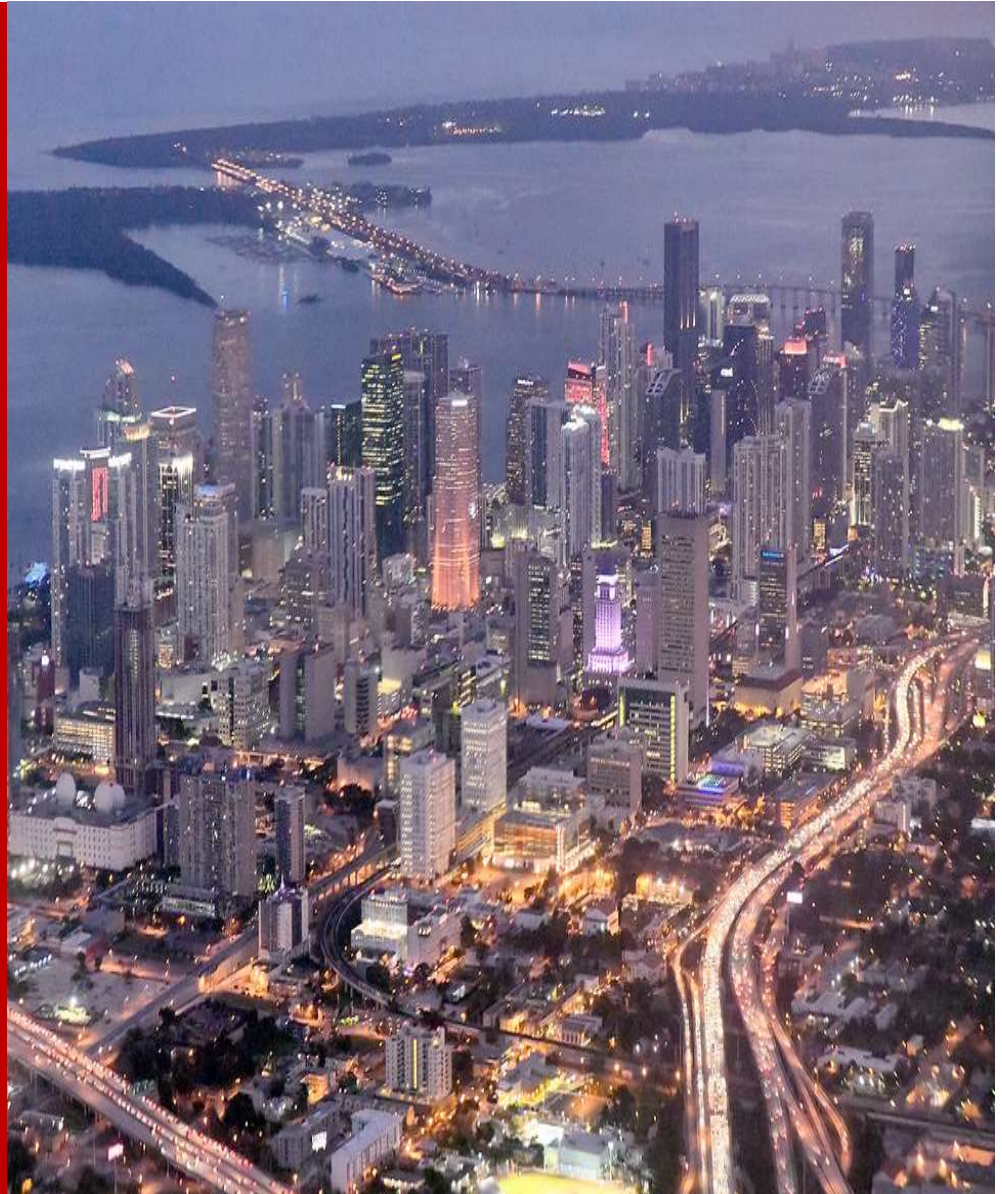
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## **REAL STATE FOCUS**

### **Large CRE Portfolios Equal Low Cap Rates**

The size of CRE private equity funds has mushroomed during the last few years. The latest blockbuster was Blackstone's, BREP X, which raised \$30.4 billion earlier this year. This is a huge amount and if levered with 60% debt, can acquire over \$76 billion of CRE assets around the world. Other large CRE private equity funds include Brookfield Asset Management's fifth real estate fund with a target of \$15 billion and Starwood Capital Group which raised \$4.2 billion for its Starwood Distressed Opportunity Fund IX, earlier this year.

The large size of these mega funds has created an investment conundrum for the sponsors. With buying power of \$76 billion for Blackstone and \$37 billion for Brookfield, these funds cannot buy a single CRE asset unless the price is at least \$250 million. Any CRE asset below this value is too small for the fund to acquire and manage. It takes just as long to complete the due diligence and closing for a \$25 million property as it does for a \$250 million property. Therefore, these mega funds have to target large CRE portfolios or even public REITs and private CRE companies to put the capital to work quickly and efficiently. Even when these large funds sell properties, they are usually portfolio sales with dozens of properties that are valued in the billions.

However, there are not many of these large portfolios or companies around to purchase and when they do come to market the sellers know that there are only a handful of qualified buyers, and they can get super premium pricing at ultra-low cap rates. The cap rates have been in the 3.0% to 5.0% range and richly priced, to say the least. In a normal CRE market, a seller would usually sell a portfolio of properties that was comprised of "pigs and queens." The pigs were the Class C properties and queens the Class As and this was a way for the seller to get rid of the worst properties in one big sale. The buyers knew this and would always extract a higher cap rate or "Kmart discount" for the deal to compensate them for the junkier properties in the portfolio.

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Today, due to the large size of these funds and the desire to bulk up their portfolios as quickly as possible with a multi-property acquisition, there is no Kmart discount, and in fact, there is a cap rate premium of about 2.0% that the buyer is paying. Buyers of large portfolio deals are so desperate for these deals that the cap rate doesn't seem to matter. This is even occurring after eleven federal fund's rate increases since March of 2022, which raised the cost of CRE debt to the 6.0% to 7.5% range from 3.50% to 4.50% only fifteen months ago. The following are examples of large CRE portfolios or companies sold during the last two years at these historically low and dangerous cap rates:

Buyer	Company Purchased	Date	Value	Estimated Cap Rate
Blackstone Group	Preferred Apartment Communities	6/22	\$5.8B	4.0%
Blackstone Group	P.S. Business Parks	8/22	\$7.6	4.0%
Blackstone Group	American Campus Communities	9/22	\$12.8B	5.0%
Prologis, Inc.	Duke Realty Trust	10/22	\$25.6B	3.5%
Public Storage	Simply Self Storage	6/23	\$2.2B	5.0%

Note: Estimated cap rates were derived from industry and broker data.

Buying these large portfolios at ultra-low cap rates in a rising interest rate environment is dangerous. Most buyers justify the high price and low cap rate by claiming that future rent increases will more than offset the high price. This may be true by using the cap rate formula with an enormous growth rate in rents of 8.0%. The formula is as follows: the risk-free rate (10-Year Treasury note at 4.0%) plus a risk premium (currently at 8.0%) less the growth rate in rents (estimated at 8.0%), which yields a cap rate of 4.0%. Rent increases of 8.0% for apartments or industrial properties in this weak economic environment may be very wishful thinking.

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### **The Painful Revaluation of CRE**

The CRE industry has been dealt a big blow with eleven interest rate hikes since March 2022 and a federal funds rate that jumped from 0.0% to 5.25%. This rapid interest rate increase has caused expected cap rates to rise to the 6.0%-8.0%+ range from the 3.5%-5.0% range only fifteen months ago and a painful revaluation of almost all CRE assets. The average CRE property's value has slid by about 25% due to this higher cost of capital. This is a risky situation for the industry; however, it does not mean that the CRE market in the U.S. will crash, similar to the Great Recession, which lasted from 2007 to 2012 when property values were down 50% on average.

Even though values are down, most properties are still generating enough cash flow to pay the annual debt and other costs like tenant improvements, leasing commissions and capital improvements. Most of the properties that are in distress were purchased at ultra-low cap rates during the last few years or are located in the high-crime Gateway cities with high vacancies and outmigration of businesses. Many of the buyers of these properties used floating rate debt to acquire the property without any interest rate protection by using an interest rate swap or rate collar. The rapid increase in interest rates since March 2022 has made it extremely difficult for these owners to cover the annual debt service on the property.

Currently, the majority of distress in the CRE industry is concentrated in office properties located in the Gateway cities and buyers who overpaid and did not prepare for the interest rate risk from the use of floating rate debt. However, the overall distress in the CRE market is not at dangerous levels as many pundits have been claiming during the last year. There is a total of \$4.5 trillion in CRE loans outstanding per the Mortgage Bankers Association of America, of which the commercial banks/thrifts own 38% or \$1.7 trillion. The distress level today is only about 2.0% of the total loans outstanding or \$90 billion, which is a cause of concern, but not Armageddon as many have claimed. If the Federal Reserve does increase the federal funds rate further from 5.25% to between 5.50% and 6.0%, then we believe the default rate will double to 4.0% or \$180 billion, a significant number, but still not a crash or CRE depression. There will be hundreds of properties in default but not enough to create an economic crash. During the Great

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Recession, the default rate for CRE loans was over 10.0%, which was a secular crash in the industry.

Public REIT stocks have also been hammered with the FTSE-NAREIT All Equity Index down (2.27%) through May 2023, (24.95%) in 2022 but up 41.30% in 2021. Since REITs are public entities, their shares get ‘marked-to-market’ immediately as compared to privately owned CRE assets, which only get marked-to-market when the property is sold or refinanced.

### Why Add CRE to a Mixed Asset Portfolio?

CRE is considered a major asset class today, alongside stocks and bonds, even though it’s an alternative asset. The total value of CRE debt and equity in the U.S. is approximately \$15 trillion and larger than all of the other alternative asset sectors including venture capital, hedge funds and private equity. Public and private REITs own about 30.0% or \$4.5 trillion of the total CRE market. Adding CRE investments to a diversified portfolio of stocks and bonds will increase return and reduce risk, as measured by the standard deviation. Private, as opposed to public REITs, real estate provides the lowest correlation with the other asset classes. Public REITs are 74% correlated with small-cap stocks and are not as good a diversifier as private commercial real estate. This low correlation of private CRE assets to the other major asset classes reduces portfolio variance and hence volatility and risk.

In Modern Portfolio Theory, there are two types of risk, systematic and nonsystematic. Systematic risk is a risk that affects all companies and cannot be eliminated. It can though, be reduced by buying low-beta stocks like utilities and REITs. Systematic risk is measured by beta, which is the volatility of a stock as compared to a market index like the S&P 500. The higher the beta, the more stock volatility and the higher the risk. The lower the beta, the less volatility and risk. Buying low-beta stocks can reduce systematic risk, but it will also lower the return. A high-flying biotech stock will have a high beta of 1.75 or higher, while a slow-growth stock like AT&T will have a low beta of .70. An investor can reduce this systematic risk by constructing a



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portfolio of low-beta stocks like AT&T but will also sacrifice return. Nonsystematic risk is the risk that affects a

specific company, like a major product recall, warranty claim, or loss of the executive management team in a plane crash. Nonsystematic risk can be eliminated by diversification of the investments in a portfolio. This means that a portfolio with 15-20 different stocks and bonds is fully diversified and nonsystematic risk is eliminated.

If private CRE investments are added to a stock and bond portfolio, the Efficient Frontier line would move up and to the left, providing more return and lower risk. The Efficient Frontier is a set of investment portfolios that are expected to provide the highest returns at a given level of risk. A portfolio is said to be efficient if there is no other portfolio that offers higher returns for a lower or equal amount of risk. An Efficient Frontier graph with and without private CRE is shown in the chart below.



As shown in the chart, the portfolio with private CRE increases return and reduces risk as the curve moves up and to the left. This is one of the primary benefits of private CRE in a mixed asset portfolio.

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### **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.

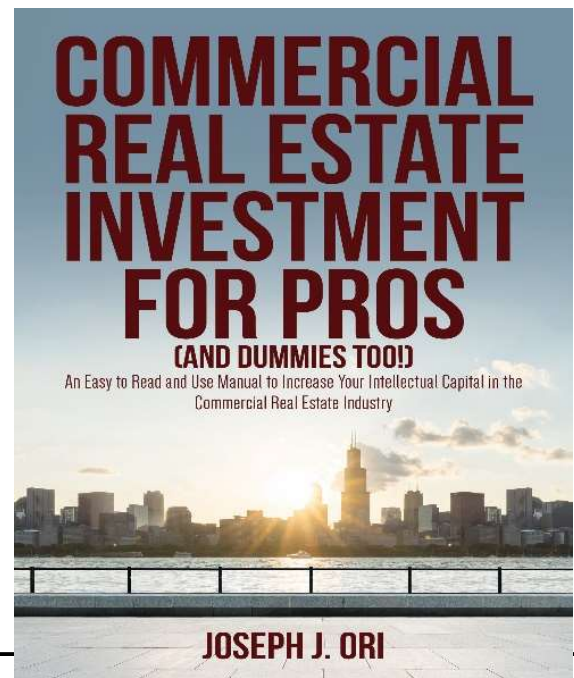
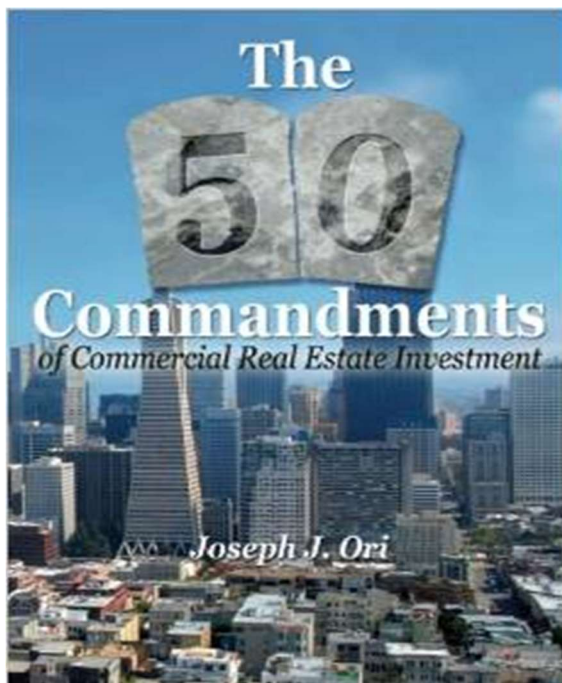
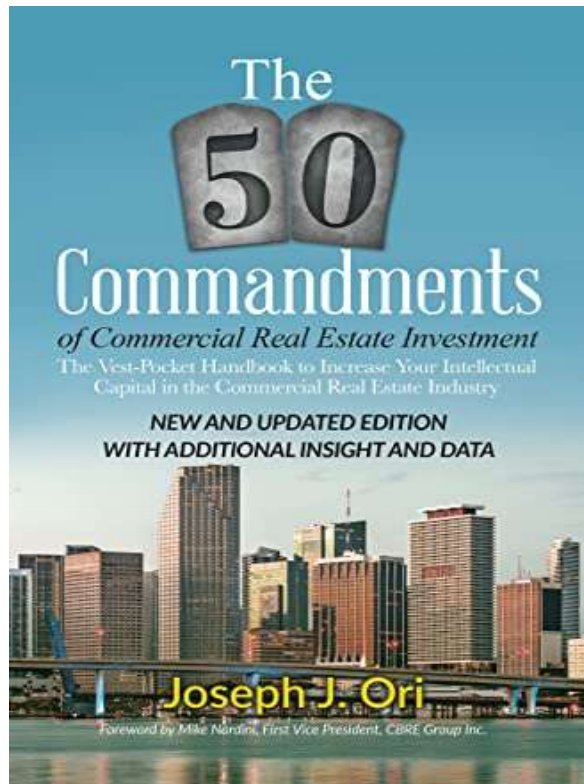
Commercial Real Estate Investment for Pros (and Dummies Too!) discusses the history, the various financial players, legal and financial structures, property types, modern portfolio theory and the financial metrics of commercial real estate investment and the commercial real estate industry. The book 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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## CRE Financing Rates

Loan Type	Mortgage Rate	Maximum Amortization	Term (years)	Maximum LTV
Permanent Loans	6.38%-10.25%+	30	10	70%
Conduit-CMBS	6.37%-7.73%+	30	10	70%
Bridge Loans	9.57%-18.57%+	Interest Only	1-3	80%
Construction Loans	9.75%-14.75%+	Interest Only	1-4	70%
Insurance Co. Loans	5.88%-7.89%+	30	10	70%
Fannie Mac/Freddie Mac	4.98%-5.79%+	30	10	80%

Commercial Loan Index Rates	
Prime Rate	8.50%
30-Day LIBOR	5.33%
30-Day SOFR (secured overnight funding rate)	5.07%
1 Year Swap	5.65%
10 Year Swap	3.87%
5 Year Treasury	3.99%
10 Year Treasury	4.04%
Federal Funds Rate	5.25%

Short-term interest rates have continued to increase with the 30-day SOFR rate up to 5.07%. Also, the Federal Reserve increased interest rates for the eleventh time with a .25% increase in the Federal Funds rate on July 26, 2023. 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](mailto:jjo@paramountcapitalcorp.com), for your real estate capital needs.

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## **CRE Deal Focus**

### **CRE Deals of the Month**

<b>Purchaser/ Sponsor</b>	<b>Seller</b>	<b>Property/ Deal</b>	<b>Price</b>	<b>Description</b>
Public Storage	Blackstone Real Income Trust Inc.	Self-Storage Portfolio	\$2.2B	A self-storage portfolio with 127 properties and 9 million square feet.
Lowe and Sunbelt Investment Holdings	Unibail-Rodamco- Westfield	Westfield Mission Valley Shopping Center, San Diego, CA	\$290M	A 1.5 million square foot shopping center.
The Broe Group	RedPeak Properties	The Seasons of Cherry Creek, Denver, CO	\$225M	A 587-unit apartment complex.
Rexford Industrial Realty	San Diego County Employees Retirement Association	Industrial Property, Los Angeles, CA	\$210M	A 595,304-square foot industrial property.

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Benderson Development and CGA Capital	Kiewit Corp.	Office Campus, Lone Tree, CO	\$205M	A 400,000-square foot Class A office campus.
Grand Lifestyles	Pathway to Living	Supportive Living Facilities, IL	\$150M	Eight supportive living facilities with 921 beds.
Boyd Watterson Asset Management	Healthcare Property Advisors	Outpatient Clinic, Austin, TX	\$142M	A 272,636-square-foot clinic.
Westcore Properties	Ryan Cos.	Hatcher Industrial Park, Waddell, AZ	\$92M	A 906,125-square foot industrial property.
Kaufman Investments and Beacon Capital Partners	Lee & Associates	875 Ave. of Americas, NY, NY	\$92M	A 26-story, office building with 265,000 square feet and built in 1926.
Landmark Properties	Saban Capital Group	The Lodges at 777, Baton Rouge, LA	\$65M	A 1,290-bed student housing property with 382 units and completed in 2011.

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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. Qualities of a Leader**

Leadership is the lifting of a man's vision to higher sights, the raising of a man's performance to a higher standard, the building of a man's personality beyond its normal limitations. Nothing better prepares the ground for such leadership than a spirit of management that confirms in the day-to-day practices of the organization strict principles of conduct and responsibility, high standards of performance and respect for the individual and his work.

#### **II. Crisis and Leadership**

Leadership is a foul-weather job. The most important task of an organization's leader is to anticipate crises. One has to make the organization capable of anticipating the storm, weathering it, and in fact, being ahead of it. You cannot prevent a major catastrophe, but you can build an organization that is battle-ready, that has high morale, that knows how to behave, that trusts itself and where people trust one another.



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### **III. The Four Competencies of a Leader**

Keep your eye on the task, not on yourself. The task matters and you are a servant. As the first such basic competence, I would put willingness, ability, and self-discipline to Listen. The second essential competence is the willingness to Communicate to make yourself understood. The next important competence is not to alibi. Say: "This doesn't work as well as it should. Let's take it back and re-engineer it." The last basic competence is the willingness to realize how unimportant you are compared to the task. Leaders subordinate themselves to the Task.

### **IV. People Decisions**

No organization can do better than the people it has. The yield from the human resource really determines the organization's performance. The quality of these human decisions largely determines whether the organization is being run seriously, whether its mission, its values and its objectives are real and meaningful to people, rather than just public relations and rhetoric.

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## REIT Statistics

Current REIT statistics for 2023 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&amp;P 500</i>	<i>NASDAQ Composite</i>
			<i>(Q2-23)</i>		
<i>5/2023</i>	-2.43%	-2.27%	-5.24%	9.65%	<b>24.06%</b>
<i>1-Year</i>	-16.02%	-15.69%	-9.99%	2.92%	<b>8.04%</b>
<i>5-Year</i>	4.00%	4.55%	6.60%	11.01%	<b>12.69%</b>
<i>10-Year</i>	5.79%	6.02%	9.41%	11.99%	<b>15.30%</b>
<i>20-Year</i>	8.15%	8.70%	9.50%	9.76%	<b>11.03%</b>
<i>Market Capitalization</i>	\$1.22T	\$1.16T	\$357B	NA	NA
<i>Dividend Yield</i>	4.64%	4.26%	NA	1.58%	NA

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## REIT Review

### Summary

This REIT valuation is on Paramount Group, Inc. (“PGRE”), a publicly-traded REIT that is engaged in the ownership, operation, management, acquisition, and redevelopment of high-quality Class A office properties. PGRE owns or has interests in 19 office properties with a gross leasable area of 13.8 million square feet.

### Property Information

As of June 30, 2023, the occupancy rate was 89.6% and the YoY decrease in the net operating income was -6.4%. All of PGREs office properties are in San Francisco and New York. PGREs three largest tenants include JPMorgan Chase & Co. (4.7% of annualized base rent), Clifford Chance (4.5% of annualized base rent) and Allianz (4.3% of annualized base).

### Corporate Data

PGRE is traded on the NYSE, is incorporated in Maryland, and is located in New York, NY. PGRE has 217.3 million common shares outstanding and a market capitalization of approximately \$1.15 billion. PGRE is an UpReit, and it owns or controls 93.4% of the interests in its operating partnership, Paramount Group Operating Partnership LP.

### New Leasing

As of June 30, 2023, PGRE entered into new leases for a total of 267,000 square feet, at an average rent of \$81 per square foot and an average lease term of twelve years. The average tenant improvements and leasing commissions were \$156 per square foot and average free rent was fourteen months.

### Management

#### *Albert Behler, 71, Chairman, CEO and President*

Albert Behler has been our Chairman, Chief Executive Officer, and President since 2014. Mr. Behler joined our company in October 1991 as President and Chief Executive Officer, where he

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oversaw all of the acquisitions and dispositions that produced our current portfolio of assets. Prior to joining our company, Mr. Behler held various leadership positions at Thyssen, a German multinational conglomerate that he joined in 1973. He ran Thyssen Saudia Company, Ltd as Managing Director and was President of Thyssen Rheinstahl in Atlanta, Georgia from 1985 to 1991. In his positions with Thyssen, Mr. Behler was responsible for, among other duties, the acquisition, financing, development, and disposition of more than ten million square feet of commercial real estate in various countries. Mr. Behler's board and association memberships presently include serving as a member of The Real Estate Roundtable, Washington, D.C.; a member of the Board of Governors of the Real Estate Board of New York; a member of the Urban Land Institute, a member of the American Council on Germany's Business Advisory Committee; and a member of the Board of Directors of Citymeals-on-Wheels. Mr. Behler is also a former member of the Executive Committee of the Greenprint Foundation and the Board of Directors of the ULI Greenprint Center for Building Performance, and a former Chairman of the Association of Foreign Investors in Real Estate (AFIRE). Mr. Behler studied law at the University of Cologne and graduated from Georgia State University with a Master's degree in Business Administration.

### Ownership

Top Institutional Holders	Shares (000's)	%
Blackrock, Inc.	27,938	12.86
Vanguard Group, Inc.	26,781	12.32
Norges Bank Investment Management	18,378	8.46
State Street Corporation	9,505	4.37
Brookfield Corporation	4,597	2.12

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Ownership Breakdown	
% Of Shares Held by All Insiders and 5% Owners	15.85
% Of Shares Held by Institutional & Mutual Fund Owners	70.14
Number of Institutions Holding Shares	262

All amounts above per Yahoo Finance



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## Financial Analysis and Valuation

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

(In millions where applicable)

Financial Data	Amounts
Real Estate Assets, Gross	\$8,165
Total Assets	\$8,367
Property Debt (at weighted average interest rates of 3.58%)	\$3,842
Stockholders' Equity	\$4,348
Revenue	\$361
Net Income (Loss)	(\$45)
Cash Flow from Operations	\$138
Unsecured Credit Facility (\$750M with \$0 used)	\$750
Market Capitalization	\$1,149
<b>Property Debt to:</b>	
Gross Real Estate Assets	47%
Market Capitalization	334%
Enterprise Value	77%
Dividend and Yield (\$.27/sh.)	5.39%
Shares Sold Short (in millions per Yahoo Finance)	11,190

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Valuation Methodology	
Q2-23 Real Estate Revenue	\$361
Q2-23 Real Estate Operating Expenses (excluding depreciation, amortization, interest expense, impairment charges plus G&A expenses)	<u>171</u>
Q2-23 Net Operating Income	\$190
Annualized Proforma Net Operating Income at 100%	\$380
Projected Average Cap Rate	<u>9.0%</u>
Projected Value of Real Estate Assets	\$4,222
Add: Net Operating Working Capital (at book value)	\$939
Investments in Unconsolidated Joint Ventures (at book value)	\$398
Real Estate Related Fund Investments (at book value)	<u>\$66</u>
Total Projected Value of the Assets of the Company	\$5,625
Less: Total Debt Per Above	<u>(\$3,842)</u>
Projected Net Asset Value of the Company	<u>\$1,783</u>
Common Shares Outstanding, 232.6M (217.3M common shares plus 15.3M partnership units)	
Projected NAV Per Share	\$7.66
Market Price Per Share on 8/15/23	\$4.95
Premium (Discount) to NAV	(35%)

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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 PGRE for the years 2018 through Q2-23 are shown in the table below:

(Millions except dividend and per share amounts)	2018	2019	2020	2021	2022	Q2-23
Gross Real Estate Assets	\$8,101	\$7,984	\$7,693	\$8,028	\$8,143	\$8,165
Property Debt	\$3,566	\$3,747	\$3,800	\$3,835	\$3,840	\$3,942
Revenues	\$758	\$769	\$714	\$726	\$745	\$361
Net Income (Loss)	\$9	(\$36)	(\$24)	(\$20)	(\$36)	(\$45)
Funds from Operations (FFO)	\$224	\$208	\$214	\$138	\$201	\$187
Return on Invested Capital (1)	3.6%	5.3%	4.5%	4.6%	4.7%	NA
Dividend Coverage (2)	1.84	1.40	3.23	1.98	1.87	4.06
Dividends Paid Per Share	\$.40	\$.40	\$.37	\$.28	\$.31	\$.14

- (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 \$.035 per quarter.

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

PGRE Total Return	5/23	1-Yr	3-yr	5-Yr
	-25.66%	-49.47%	-13.90%	-19.02%

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As shown above, our net asset value per share for PGRE is \$7.66/sh., compared to a market price of \$4.95/sh. Current average cap rates for office properties per our industry experience and CBRE's Cap Rate Survey are in the 6.0% to 10.0% range, depending on the location, tenancy, and occupancy. We have used an average cap rate of 9.0% due to PGREs concentration of office properties in only two cities.

### Valuation Analysis

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

#### *Strengths:*

- An attractive dividend yield of 5.39%.

#### *Concerns:*

- REIT prices will decline if interest rates increase.
- A high debt to enterprise value of 77%.
- The dividend was cut by 55% in Q2-23.
- The return on invested capital has been less than 5.0% since 2018.
- All of the PGREs properties are in San Francisco and New York, the two worst office markets in the country.
- PGREs portfolio is not diversified by location which increases risk.

#### *Recommendation:*

PGRE is trading at a discount of 35% to our NAV per share, however, we would not be a buyer of the stock due to the concentration of the portfolio in San Francisco and New York.

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A five-year price chart for PGRE 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

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