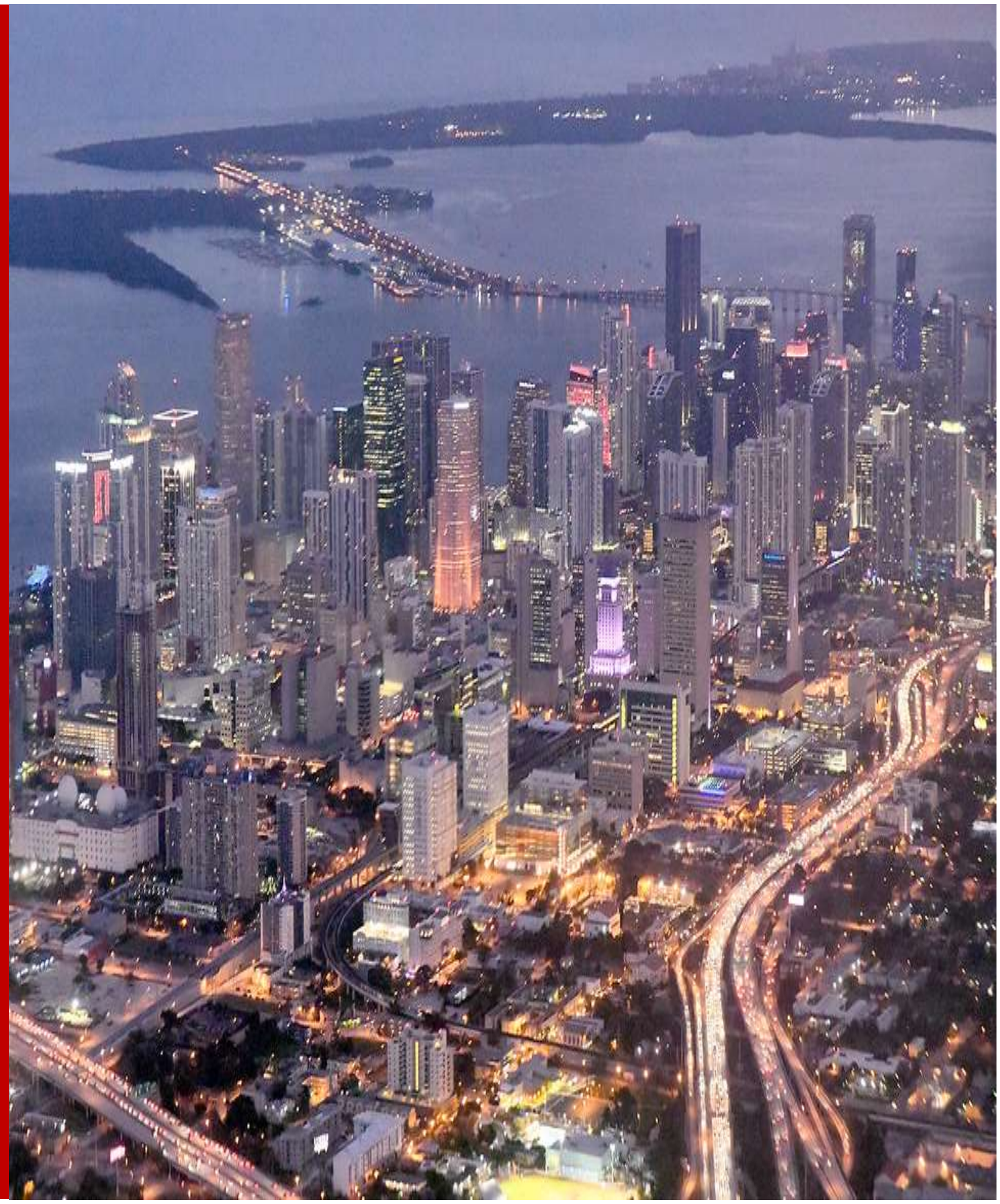
View of the Market

Volume XV/Issue 9/ September 2023

Strategy and Insight for the Commercial Real Estate Industry

A Publication of Paramount Capital Corporation

INSIDE THIS ISSUE



View of the Market

Volume XV/Issue 9/ September 2023

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REAL STATE FOCUS

Determining the Cost of Capital for a Private Real Estate Company

One of the most important maxims of finance is a company's cost of capital. A company needs to know what its capital costs so that it can make shareholder value investments that generate returns greater than its cost of capital. The cost of capital for a company is determined by calculating and weighting the cost of each component of a firm's capital structure. This is known in finance as the weighted average cost of capital (WACC). An operating company or REITs capital structure may include; long-term debt, preferred stock, and common stock. Each of these components has a specific cost that is determined by financial formulas. The cost of debt is the yield on the debt times one minus the tax rate. The cost of preferred stock is the dividend divided by the stock price. The cost of common stock or equity is determined by using one of two models. The dividend discount model divides the company dividend per share by the stock price and then adds the dividend growth rate or the capital asset pricing model, which takes the risk-free rate and adds it to the product of the equity risk premium times the company's stock Beta. The equity risk premium is the return investors need over the risk-free rate to invest in risky common stocks. Beta is the volatility of a REIT stock to the market, like the S&P 500 Index.

These calculations are very common in corporate America and even in the REIT world as REIT stocks have characteristics similar to operating companies for valuation purposes. However, what if you own a small or midsize private real estate investment firm, what is your WACC? In this case, the formulas are the same and the calculations are much simpler. We will calculate the WACC using the following data for a hypothetical firm, USA Realty Investments, a regional property investment firm that owns 3,000 apartment units in Florida. The firm's portfolio is valued at $375 million and is financed with 65% debt at 6.0% interest only and the balance in equity from a group of institutional investors arranged by USA.

USA is a private CRE firm and like most real estate investment firms, only has two components in its capital structure, mortgage debt and investor equity. Therefore, two of the formulas above can be used to calculate the firm's WACC. First, we can easily calculate the cost of debt as the yield on the debt time one minus the company's tax rate. Since USA is a private real estate firm and its debt is private mortgage debt and not publicly traded, the cost would be calculated as follows: Cost of debt = yield or current mortgage interest rate times one minus the maximum individual tax rate. Almost all institutional CRE deals are owned by flow-through entities in limited partnerships and therefore we are using the top individual tax rate of 37%. The yield on the debt is shown after tax because interest on the debt is deductible for tax purposes. The cost of debt is therefore; 6.0% (1-37%) = 3.78% X 65% (weight in the capital structure) = 2.46%.

Assuming that USA is comparable to a public apartment REIT, the cost of USA's equity capital can be determined by the capital asset pricing model discussed above as follows:
Cost of equity = risk-free rate + Beta (equity risk premium). The risk-free rate is the average interest rate on 10-year Treasury securities during the last five years estimated at 3.5%. Since USA is an apartment investor, we can use the average Beta of the public apartment REITs of approximately .85 and an estimated equity risk premium of 10.0% for a cost of equity of; 3.5% + .85(10.0%) or 12.0%. The equity risk premium for a real estate firm is the return in excess of the risk-free rate sought by equity investors and in this example, it's 10.0%. The weighted cost of equity capital is 12.0% times the weight in the capital structure of 35% or 4.20%. The WACC is therefore summarized as follows:

Capital	Amount	Weight	Cost	WACC (column 3 x 4)
Mortgage Debt	$243,750,000	65%	3.78%	2.46%
Equity Investment	$131,250,000	35%	12.0%	4.20%
Total	$375,000,000	100%		6.66%

Strategy and Insight for the Commercial Real Estate Industry

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As shown above, USA's WACC is 6.66% and this is the minimum rate of return or hurdle rate that USA will use on its real estate investments. The WACC is lower than most public operating companies' which typically have WACCs of 8.0% to 12.0%, due to the higher percentage of debt, typically 60% to 75% of value, allowable on CRE investments. Even though debt is cheaper than equity, most public operating companies have less than 30% debt in their capital structure. Alternatively, if USA was financed with all equity, its cost of equity capital could be estimated as the expected return to the firm's equity investors, which has averaged 10%-15% over the investment term. With an average return of 12%, USA's cost of equity would be 12%.

Five Themes for CRE Investment in These Turbulent Times

The CRE industry is facing some tumultuous times with higher interest rates, less debt and equity capital available, a multitude of loan defaults and foreclosures and a slowing economy. However, we here at VOM believe that there are some "green shoots" for the next couple of years and our five themes for investment in these turbulent times are as follows.

1. Extend to the End

During the Great Recession from 2007 to 2012, many CRE lenders were in financial turmoil and to minimize additional loan defaults began a program of "extend and pretend." Today, it is "extend to the end" and the end refers to when the Federal Reserve will end its interest rate-raising program. We believe the Fed will make one more .25% raise in the federal funds rate this year to 5.50% and then it will stand firm for the next few months and begin reducing rates in the first half of 2024. This will create a big boom in CRE investment in 2024 and beyond.

2. Adore CRE in 2024

When the Fed begins lowering interest rates in 2024, the CRE industry will boom, and this will be an excellent opportunity to acquire CRE assets including those that have been in distress including office buildings, retail centers and senior housing assets. There will also be an opportunity to acquire defaulted notes on CRE properties. The job market will still remain robust, which will support a growing CRE market.

View of the Market

Volume XV/Issue 9/ September 2023

Strategy and Insight for the Commercial Real Estate Industry

A Publication of Paramount Capital Corporation

3. Put on Your Distressed Investing Hat

CRE investment firms need to begin raising capital for distressed funds to take advantage of defaulted loans, distressed property, and deeply discounted property in the next two years. Since the beginning of this year, there has been about $50 billion in capital raised for distressed investment along with about $100 billion in existing CRE funds or a total of $150 billion for distressed assets. Office assets in the high-crime Gateway cities will be available for 40% to 50% discounts from per-covid values and although these areas may need another year or two to turn around, these will turn out to be great bargains.

4. Buy Midwest Suburban Apartments

The national apartment market continues to do well, but apartments in the suburban Midwest should do exceptionally well and are available at attractive cap rates of 6.0% to 8.0%+ as compared to 4.0%-6.0% for apartments on the Coasts and in the high-growth Sunbelt markets. Midwest apartments only saw average rents rise about 3.0% during the last five years as compared to coastal and Sunbelt markets, where rents were up 50% to 100%+ during the same period. Many markets in Florida saw rents double during this period. Midwest apartments will be available at enticing risk-adjusted cap rates.

5. Buy Suburban Office in Gateway Markets

The office markets in many of the Gateway cities with high crime and outmigration have been in severe distress the last few years, however, the suburban markets that ring these cities have seen a big in migration boom and demand for office space will be strong. Investors should seek to acquire suburban office buildings that are available at cap rates of 7.0%-9.0%+ in these markets and many of these buildings will see high 90%+ occupancies.

View of the Market

Volume XV/Issue 9/ September 2023

Strategy and Insight for the Commercial Real Estate Industry

A Publication of Paramount Capital Corporation

Top 15 Investing Mistakes in CRE

The CRE industry is different than all other industries in that it is a transaction-based model. The lifeblood of the industry is dependent on sale, financing, and lease transactions. The more transactions there are, the more money the industry and everyone in it makes and the more successful the business. 2021 was a record year for transaction volumes and a phenomenal boom year for CRE. The most successful companies and individuals in the industry are usually adept at selling, financing and/or leasing CRE property. However, in pursuing these transactions the same key mistakes are made over and over again which usually results in poor performance, the loss of equity in a property or the loss of the property in foreclosure. We here at VOM have produced the 15 biggest investing mistakes in CRE that are the root cause of bad deals as follows.

1. Acquiring properties at low cap rates. Cap rates below 5.0% are not justified even if the investor believes that future rent increases, which may not happen, will make up for the low initial return. Buying CRE at sub-5.0% cap rates is like buying a tech stock at a 100-price-to-earnings ratio.

2. Not diversifying a national portfolio by property type, location, and industry. Many national firms diversify a large fund by type and location but forget about industry diversification. If an investor buys only apartments and offices in Silicon Valley, 70% of the apartment tenants work in the tech industry and 70% of the office tenants are technology or related companies. If the tech industry retracts in a downturn, many of the apartment tenants may be laid off and unable to pay their rent or may move home or double up with roommates. This will negatively affect the apartment market. Many of the office tech firms may default on their leases or shrink their space requirements, which will negatively affect the office market.

3. Not performing property level and financial due diligence on all properties in a portfolio acquisition. Many institutional investors that acquire large portfolios consisting of dozens or hundreds of properties do not do sufficient property-level due diligence. They only look at the larger and more valuable properties in the pool or hire inexperienced third-party firms to do the property-level due diligence.

4. Acquiring properties with negative leverage. Negative leverage occurs when the cap rate is less than the mortgage constant, which means the cash-on-cash return will be lower than the cap rate, which is a "no-no" in CRE. Many firms acquire properties with negative leverage believing that future rent increases will more than make up for the low initial return.

5. Using short-term floating rate debt without the protection of a swap or collar to finance a long-term real estate asset or portfolio. This is what has occurred during the last two years as the Fed abruptly raised the federal funds rate from 0.0% to 5.25%. Many CRE investors were caught flat-footed by the quick increase in interest rates from floating rate debt and no interest rate protection and are now scrambling to lower their financing costs and risk.

6. In underwriting an acquisition, using a terminal cap rate that is less than the going-in cap rate. This is often done by the acquisition or other internal group within a large CRE firm to "juice up" the internal rate of return on the equity in a deal underwriting.

7. Institutional investors who commit capital to sponsors who have inexperienced senior management teams. The senior management team should have gray hair and have been through at least the last two secular CRE downturns of 1987-1992 and 2007-2012. One of the most important drivers of success in CRE investment is having individuals on the team with significant and long-term experience and knowledge in all property types, markets, and economic recessions.

8. Using overly optimistic rent projections in underwriting a deal. This often occurs when the acquisition or other internal group wants to make the deal look better and the deal to be developed or acquired.

9. Not analyzing the sales volumes per square foot of retail tenants, a key metric when buying shopping centers. One of the most important metrics when buying shopping centers after the cap rate, is the sales per square foot of the anchor tenants. High sales per square foot means the center is in an A location, will remain fully leased and in high demand from tenants and shoppers.

10. Using high leverage of more than 75%. One of the highest risks in CRE investment is using high leverage and this was one of the causes of the Great Recession from 2007 to 2012.

11. Not giving senior-level employees an equity interest in the company, portfolio, or fund. This is what is known as the "golden handcuffs" in CRE. If you don't take care of your key people, they will leave and become your competitors.

12. Not incorporating the 15 risks of CRE in a real estate firm. The risks include cash flow, value, tenant, market, economic, interest rate, inflation, leasing, management, ownership, legal and title, construction, entitlement, liquidity and refinancing into the firm's investment strategy.

13. Investing in property sectors like hotels and senior housing, which are more operating businesses than real estate deals, in which the investment firm has no experience. Hotels are typically 70% operating business, and 30% real estate deal and senior housing is 80% to 100% operating business and 0% to 20% real estate.

14. Not obtaining the Kmart discount when acquiring a large portfolio of CRE assets. Whenever a large CRE portfolio trades it is typically made up of Class A queens, Class B pigs and average Class B deals, and the buyer needs a discount of at least a 1.0% higher cap rate for the risk of the Class C properties.

15. Not checking the formulas in an XL underwriting workbook, as there is at least one formula error in every CRE underwriting worksheet. This is a common occurrence when preparing a complicated Excel underwriting workbook and firms should make sure that all formulas are rechecked by an independent party.

View of the Market

Volume XV/Issue 9/ September 2023

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

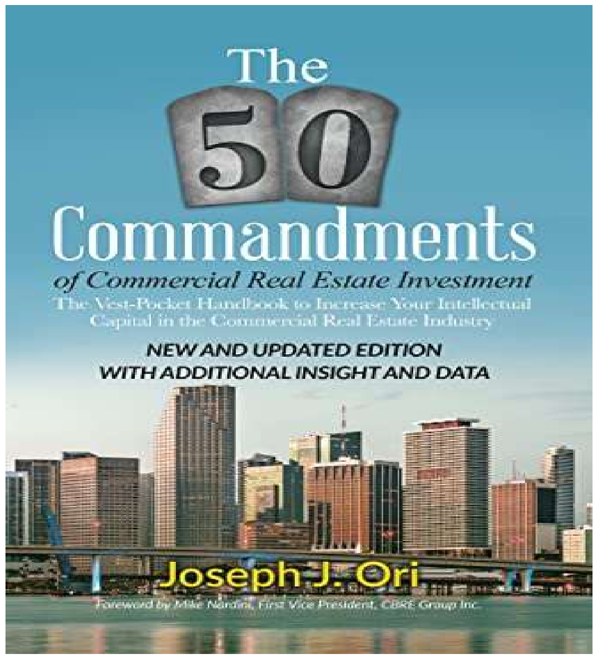
The editor of this newsletter, Joseph Ori, is pleased to offer his three CRE books for sale, "The Fifty Commandments of Commercial Real Estate Investment" Edition I and II and "Commercial Real Estate Investment for Pros (and Dummies Too!)." All books are available on Amazon and other book outlets in Kindle, and soft and hardcover from $8.99 to $24.99.

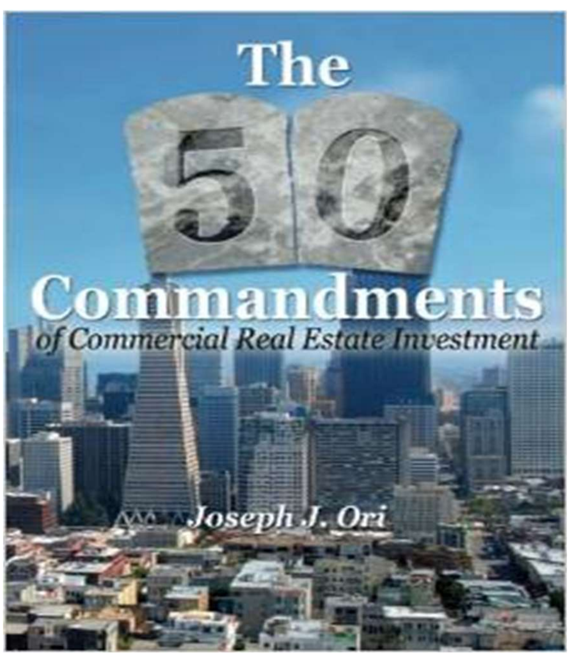
Both editions of The Fifty Commandments of Commercial Real Estate Investment compile the choice pieces of advice Mr. Ori has amassed over 35 years in the CRE industry. Mr. Ori lists essential dos and don'ts, mistakes, and successful strategies with a mixture of critical analysis and a keen sense of satirical 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.

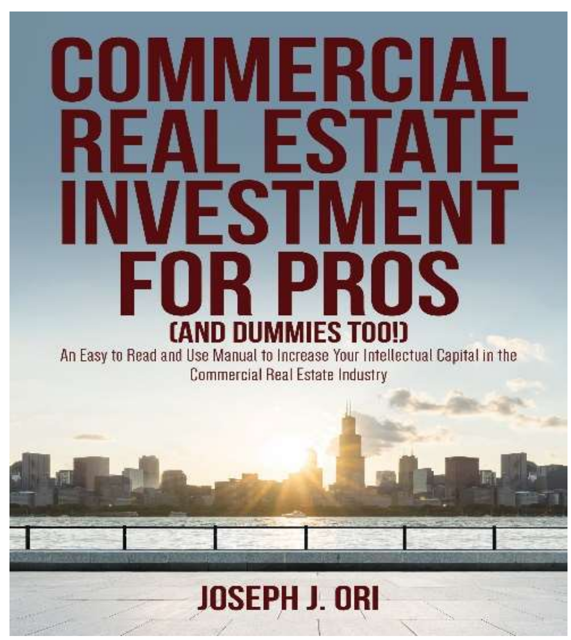
Commercial Real Estate Investment for Pros (and Dummies Too!) discusses the history, the various financial players, legal and financial structures, property types, modern portfolio theory and the financial metrics of commercial real estate investment and the commercial real estate industry. The book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

Strategy and Insight for the Commercial Real Estate Industry

A Publication of Paramount Capital Corporation







View of the Market

Volume XV/Issue 9/ September 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	6.38%-10.50%+	30	10	70%
Conduit-CMBS	6.37%-7.73%+	30	10	70%
Bridge Loans	9.66%-18.66%+	Interest Only	1-3	80%
Construction Loans	10.00%-15.00%+	Interest Only	1-4	70%
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	8.50%
30-Day LIBOR	5.44%
30-Day SOFR (secured overnight funding rate)	5.31%
1 Year Swap	5.64%
10 Year Swap	3.87%
5 Year Treasury	3.99%
10 Year Treasury	4.20%
Federal Funds Rate	5.25%

Short-term interest rates have continued to increase with the 30-day SOFR rate up to 5.31%. Also, the Federal Reserve will meet on September 19th and 20th and may increase the federal funds rate by another .25%. The above financing rates and data are courtesy of Paramount Capital Corporation and feel free to contact Joseph Ori, Executive Managing Director, Paramount Capital Corporation, jjo@paramountcapitalcorp.com, for your real estate capital needs.

View of the Market

Volume XV/Issue 9/ September 2023

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
Kimco Realty	RPT Realty	Stock Acquisition of RPT	$2B	A portfolio of 56 shopping centers and joint venture assets.
KSL Capital Partners	Hersha Hospitality Trust	Stock Acquisition of Hersha Hospitality Trust REIT	$1.4B	A portfolio of 25 hotels with 3,811 rooms.
Bridge Multifamily Fund Manager	Harbor Group International	Apartment Portfolio	$460M	A portfolio of six apartment properties with 1,722 units.
Kimco Realty	JBG Smith	Stonebridge at Potomac Town Center, Woodbridge, VA	$172M	A 504,000 square-foot retail center that is 96% leased.

View of the Market

Volume XV/Issue 9/ September 2023

Strategy and Insight for the Commercial Real Estate Industry

A Publication of Paramount Capital Corporation

EQT Exeter	The McShane Cos.	Southeast Gateway Business Park, Savannah, GA	$120M	A 1.2 million square foot business park.
Rithm Capital Corp., American Real Estate Partners, and Greenbarn Investment Group	Dream Finders Homes	CityHouse Ashburn Station, Ashburn, VA	$120M	A future 200-unit subdivision of SFR townhomes.
Penzance	AvalonBay Communities	Jasper Columbia Pike, Arlington, VA	$105M	A 269-unit apartment property.
Capital Metro	CIM Group	Fifth + Tillery Office Building, Austin, TX	$87M	A three-story, 182,700-square-foot office building.
Quarry Capital	Cortland	The View at TPC, San Antonio, TX	$71M	A 416-unit apartment property completed in 2014.

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. Placements That Fail

There is no such thing as a perfect record in making people decisions. Successful executives follow five ground rules. First, the executive must accept responsibility for any placement that fails. Second, the executive does have the responsibility to remove people who do not perform. Third, just because a person doesn't perform in the job, he or she was put in doesn't mean that the person is a bad worker whom the company should let go. Fourth, the executive must try to make the right people decisions for every position and Fifth, newcomers best be put in an established position where expectations are known, and help is available

II. The Crucial Promotions

The crucial promotion is into the group from which tomorrow's top people will have to be selected. If a company is to obtain the needed contributions, it must reward those who make decisions. The crucial promotion is not a person's first, though it may be the most important one to his and her career. Nor is it the final one into the top position; there a management must choose from a small, already preselected group.

View of the Market

Volume XV/Issue 9/ September 2023

Strategy and Insight for the Commercial Real Estate Industry

A Publication of Paramount Capital Corporation

III. Psychological Insecurity

Insecurity permeates the entire industrial situation. It creates fear and since it is fear of the unknown and the unpredictable, it leads to a search for scapegoats and culprits. Only if we restore the worker's belief in rationality and predictability of the forces that control his job, can we expect any policies in the industrial enterprise to be effective.

IV. Managing Knowledge Workers

The management of people is a "marketing job." And in marketing one does not begin with the question; "What do we want." One begins with the questions; "What does the other party want?" What are its values?" What are its goals?" What does it consider results?" The key to maintaining leadership in the economy and the technologies that are emerging is likely to be the social position of the knowledge professional and social acceptance of their values.

View of the Market

Volume XV/Issue 9/ September 2023

Strategy and Insight for the Commercial Real Estate Industry

REIT Statistics

Current REIT statistics for 7/2023 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.

Period	*All REITs*	*All Equity REITs*	*NCREIF NPI Levered Index (Q2-23)*	*S&P 500*	*NASDAQ Composite*
7/2023	5.30%	5.03%	-5.24%	20.65%	**37.71%**
1-Year	-10.12%	-10.15%	-9.99%	13.02%	**16.82%**
5-Year	4.59%	5.07%	6.60%	12.20%	**14.35%**
10-Year	6.79%	6.93%	9.41%	12.66%	**15.93%**
20-Year	8.15%	8.69%	9.50%	10.12%	**11.14%**
Market Capitalization	$1.31T	$1.25T	$357B	NA	NA
Dividend Yield	4.31%	3.97%	NA	1.46%	NA

View of the Market

Volume XV/Issue 9/ September 2023

Strategy and Insight for the Commercial Real Estate Industry

A Publication of Paramount Capital Corporation

REIT Review

Summary

This REIT valuation is on Broadstone Net Lease, Inc. (“BNL”), a publicly-traded REIT that leases industrial, healthcare, restaurant, retail, and office commercial properties under long-term lease agreements. BNL owns or has interests in 801 net lease properties in 44 U.S. states with a gross leasable area of 38.5 million square feet.

Property Information

As of June 30, 2023, the occupancy rate was 99.4% and the YoY increase in the net operating income was 21.3%. BNLs three largest tenants include Roskam Baking Company (4.0% of annualized base rent), AHF Products (2.4% of annualized base rent) and Jacks Family Restaurants (1.9% of annualized base).

Corporate Data

BNL is traded on the NYSE, is incorporated in Maryland, and is located in Rochester, NY. BNL has 187.2 million common shares outstanding and a market capitalization of approximately $3,241 billion. BNL is an UpReit, and it owns or controls 95.3 % of the interests in its operating partnership, Broadstone Net Lease LLC. BNLs debt is rated BBB by Standard and Poor’s and Baa2 by Moody’s.

Lease Data

As of June 30, 2023, BNLs portfolio had an average lease term of 10.7 years, a 2.0% average annual escalation, and 15.3% of the tenants were investment grade credit-rated tenants.

Management

John D. Moragne, 40, CEO and Director

Mr. Moragne has served as our Chief Executive Officer and as a member of our Board of Directors since March 2023. Mr. Moragne previously served in various roles of the Company, including as our Executive Vice President and Chief Operating Officer from 2018 to 2023, our

General Counsel and Chief Compliance Officer from 2016 through 2018, and as the Company's Secretary from 2016 to 2021. Prior to joining the Company, Mr. Moragne was a corporate, securities and M&A attorney from 2007 to 2016. Mr. Moragne holds a B.A. from SUNY Geneseo and a J.D. from The George Washington University Law School.

Ownership

Top Institutional Holders	Shares (000's)	%
Vanguard Group, Inc.	28,052	14.98
Blackrock, Inc.	17,809	9.51
Principal Financial Group, Inc.	13,904	7.42
State Street Corporation	8,831	4.72
United Capital Financial Advisors, LLC	5,988	3.20

Ownership Breakdown	
% Of Shares Held by All Insiders and 5% Owners	.76%
% Of Shares Held by Institutional & Mutual Fund Owners	79.9%
Number of Institutions Holding Shares	338

All amounts above per Yahoo Finance

View of the Market

Volume XV/Issue 9/ September 2023

Strategy and Insight for the Commercial Real Estate Industry

A Publication of Paramount Capital Corporation

Financial Analysis and Valuation

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

(In millions where applicable)

Financial Data	Amounts
Real Estate Assets, Gross	$4,954
Total Assets	$5,368
Property Debt (at weighted average interest rates of 5.23%)	$1,941
Stockholders' Equity	$3,261
Revenue	$228
Net Income (Loss)	$99
Cash Flow from Operations	$136
Unsecured Credit Facility ($1B with $123 used)	$877
Market Capitalization	$3,241
Property Debt to:	
Gross Real Estate Assets	39%
Market Capitalization	60%
Enterprise Value	37%
Dividend and Yield ($1.12/sh.)	6.78%
Shares Sold Short (in millions per Yahoo Finance)	3,220

View of the Market

Volume XV/Issue 9/ September 2023

Strategy and Insight for the Commercial Real Estate Industry

A Publication of Paramount Capital Corporation

Valuation Methodology	
Q2-23 Real Estate Revenue	$228
Q2-23 Real Estate Operating Expenses (excluding depreciation, amortization, interest expense, impairment charges plus G&A expenses)	29
Q2-23 Net Operating Income	$199
Annualized Proforma Net Operating Income at 103%	$410
Projected Average Cap Rate	7.0%
Projected Value of Real Estate Assets	$5,857
Add: Net Operating Working Capital (at book value)	$424
Property Under Development (at book value)	$37
Total Projected Value of the Assets of the Company	$6,318
Less: Total Debt Per Above	($1,941)
Projected Net Asset Value of the Company	$4,377
Common Shares Outstanding, 196.4M (187.2M common shares plus 9.2M limited liability company units)	
Projected NAV Per Share	**$22**
Market Price Per Share on 9/15/23	**$16**
Premium (Discount) to NAV	**(27%)**

View of the Market

Volume XV/Issue 9/ September 2023

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 BNL 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	$2,683	$3,457	$3,704	$4,205	$5,008	$4,954
Property Debt	$1,445	$2,004	$1,612	$1,714	$2,021	$1,941
Revenues	$237	$298	$321	$382	$407	$228
Net Income (Loss)	$69	$79	$51	$102	$122	$99
Funds from Operations (FFO)	$150	$167	$192	$256	$273	$153
Return on Invested Capital (1)	6.0%	5.7%	6.2%	6.9%	6.3%	NA
Dividend Coverage (2)	NA	NA	2.46	1.55	1.42	1.42
Dividends Paid Per Share	NA	NA	$.385	$1.025	$1.08	$1.12

(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 $.28 per quarter.

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

BNL Total Return	7/23	1-Yr	3-yr	5-Yr
	4.04%	-23.01%	NA	NA