

View of the Market

Volume XVI/Issue
4/April 2024

Strategy and Insight for the Commercial Real Estate Industry

A Publication of Paramount Capital Corporation

INSIDE THIS ISSUE

Real Estate Focus:

- Get Ready for a CRE Boom!
- How to Underwrite a CRE Property
- Developing a CRE Investment Strategy for the 2024/25 Boom
- CRE Books by Our Editor, Joseph Ori
- CRE Financing Rates Courtesy of Paramount Capital Corporation

CRE Deal Focus:

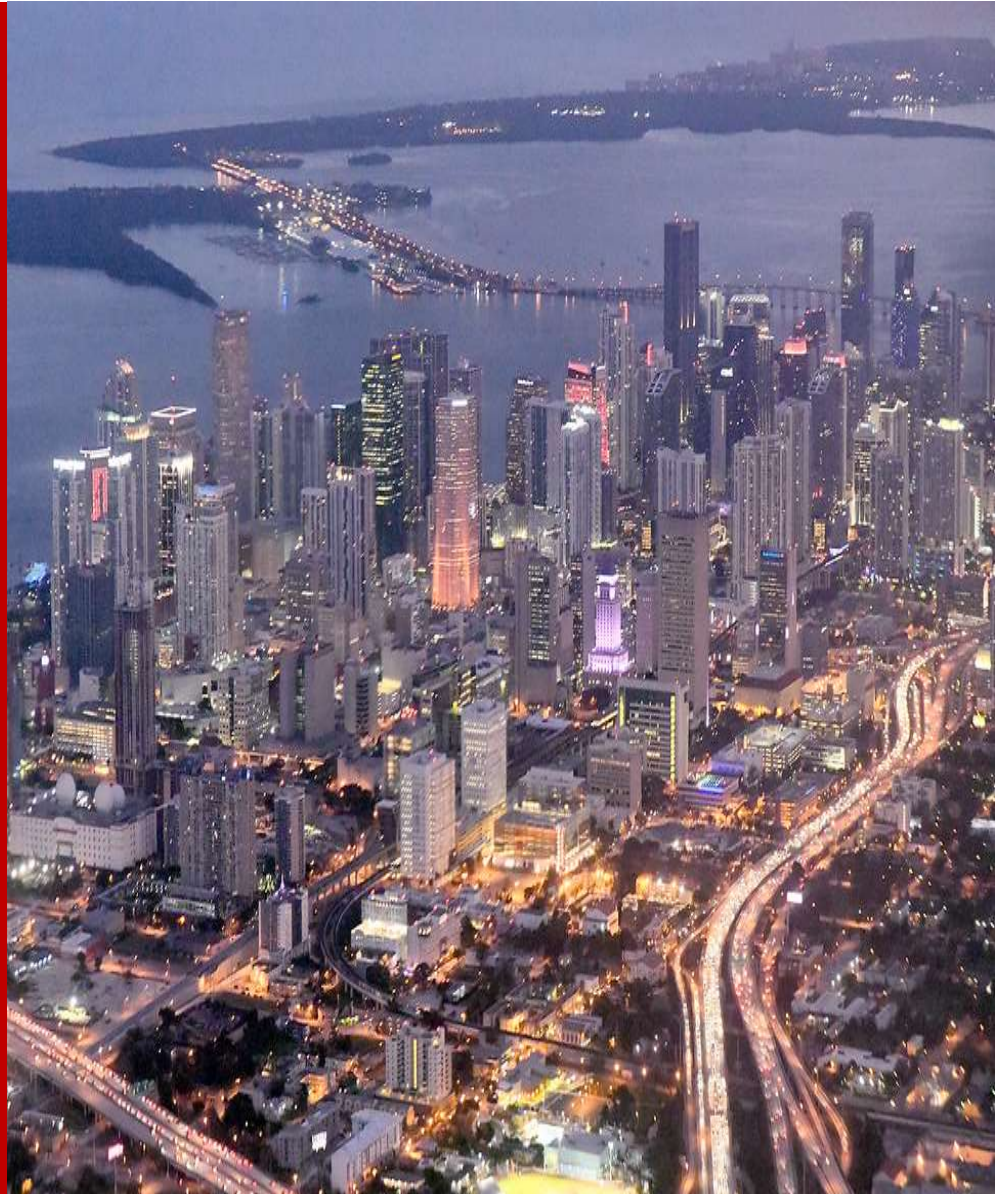
- CRE Deals of the Month

Corporate Finance Focus:

- The Daily Drucker
- The Failures of Abraham Lincoln

REIT Focus:

- REIT Return Statistics
- REIT Review: Brandywine Realty Trust, an Office REIT



Strategy and Insight for the Commercial Real Estate Industry

A Publication of Paramount Capital Corporation

REAL STATE FOCUS

Get Ready for a CRE Boom!

The CRE industry has been in the doldrums for the last two years due to historic interest rate increases courtesy of the Federal Reserve. The Federal Reserve raised the federal funds rate beginning in March of 2022 from 0.0% to 5.25%, where it stands today. All the pundits who predicted over the last two years that the CRE market would crash, and many community and regional banks would go under from the weight of defaulted CRE loans, have again been proven wrong. We here at VOM have been steadfast in our writings and analysis that defaulted CRE loans would only be about 2% of total loans of \$4.6 trillion or \$92 billion and this would not crash the CRE market or banking industry. Many market watchers are now opining that the Fed will only lower rates two or three times in the later part of 2024 and the same in 2025. We also don't agree with this prediction and see the Fed lowering rates beginning in the second quarter of this year with the federal funds rate at 4%-4.25% by the of this year and at 3.0%-3.5% by the end of 2025.

Even though a drop in the funds rate of 1.0%-1.25% is not huge, it will be a significant catalyst for a mini-boom in the CRE industry in the last half of this year. If rates are lowered further in 2025, an even bigger boom will arrive in CRE similar to the market in 2012 and at the tail end of the Great Recession. There is so much pent-up demand right now to do deals and with over \$150 billion sitting idle in real estate private equity funds, there is ample capital to buy distressed real estate assets and loans. The entire brokerage community that has made very little money during the last two years will be aggressively doing new deals. Since the Fed began raising interest rates, transaction volumes in the CRE industry have dropped 70%. Sales, leasing, and financing transactions in the next two years will skyrocket. Developers will also seek to start the new development projects that were mothballed the last two years and skittish banks, and other regulated lenders will again seek to fill their coffers with new loan applications. The shadow or unregulated lenders have increased their market share of total loans to about 10% in the last

Strategy and Insight for the Commercial Real Estate Industry

A Publication of Paramount Capital Corporation

few years will also be aggressively seeking new loan deals and will fill any void left open by the regulated lenders.

Even institutional investors like pension funds, endowments, and sovereign wealth funds with billions in funds earmarked for CRE that have been dormant the last two years will be back in the market seeking to place new capital. The REIT industry which has seen the FTSE-NAREIT All Equity Index fall 24.95% in 2022, increase 11.36% in 2023 and fall 4.86% through January of 2024, will see total returns of 6%-8% in 2024 and 20%+ in 2025. Distressed sales will be a key sector during this boom, especially office assets in high-crime urban cities around the country. Investors should also seek senior housing investments as this sector, which was much aligned during the pandemic, has made a strong comeback in rental rates and occupancy and there is a dearth of capital in this sector. All CRE market participants need to sharpen their pencils and get ready for this upcoming boom as great investment opportunities will abound.

How to Underwrite a CRE Property

Analyzing and underwriting a commercial property is a critical function in the CRE investment process. CRE deal underwriting is the practice of preparing a five-to-ten-year proforma cash flow statement of the property's income, operating expenses, net operating income and cash flow to equity. While this task is simple in definition, it requires a very detailed analysis and numerous financial and operating assumptions. If the analysis involves a commercial property with a large number of leases, then a software program like Argus Enterprise is required to input the lease data and generate the gross potential rent and cash flows for the property. The property proforma is the basis for calculating the cap rate, net present value on the net operating income, cash flow to equity, the internal rate of return on the equity and whether the projected returns meet the investment requirements of the buyer and its investors.

There are many important assumptions required to prepare the cash flow proforma. The key inputs include; market rent, option rents, vacancy, lease downtime, percentage of tenants with no lease options that will sign a new lease, operating expenses, tenant improvements and leasing

Strategy and Insight for the Commercial Real Estate Industry

A Publication of Paramount Capital Corporation

commissions, capital improvements and other operating metrics. The table below is a summary of the primary underwriting assumptions for apartments and commercial properties. In most CRE firms, the assumptions are provided by senior management as they have the history, knowledge, and experience of many years in the CRE business.

Underwriting Metrics	Comments
Apartments:	
1. Market Rent	What is the market rent for vacant units by unit type?
2. Vacancy	What is the underwriting vacancy, 5%, 10% or other?
3. Other Income	What are the types of other income (pet fees, parking, late fees, etc.)?
4. Operating Expenses	
a. Insurance	What is the annual cost per the company's insurance policy and experience?
b. Real Estate Taxes	Should be adjusted to the state and county laws and local assessment.
c. Salaries and Wages	Based on property staffing.
d. Repairs and Maintenance	Usually a per-unit amount.
5. Space Down Time	How many months will the unit be vacant upon lease turnover, and this is typically 2-3 months?
6. New Lease Turnover Costs	What are hard costs (repairs & maintenance) and soft costs (lost rent) upon lease turnover?
7. Inflation rate	What is the inflation rate for the proforma?

Strategy and Insight for the Commercial Real Estate Industry

A Publication of Paramount Capital Corporation

8. Terminal Value Cap Rate	Should be the same as the going-in or acquisition cap rate.
9. Management Fee	What is the annual property management fee, 5%, 6%, or another amount?
10. Underwriting Period	What is the underwriting period, 5, 7 or 10 years?
11. Discount Rate	The discount rate should be the risk-free rate plus a CRE risk premium (today it is typically 8% to 10%).
Commercial Properties:	
1. Market Rent	What is the market rent for vacant spaces and new leases?
2. Lease Options	How will lease options be exercised? Usually, it's assumed that all options are exercised.
3. At Lease End with no Options, What Percentage of Tenants Will Renew?	Usually, a set percentage at 70%-80% will be used as tenants renewing a lease.
4. Space Down Time	How long will a space remain vacant before securing a new tenant and this is typically 3-6 months.
5. Length of New Leases	It depends on the market and the size of the space, but typically 3, 5 or 7 years.
6. Tenant Improvements and Leasing Commissions	It depends on the market and the need for new leases and renewals and are typically set at square foot amounts.

Strategy and Insight for the Commercial Real Estate Industry

A Publication of Paramount Capital Corporation

7. Percentage Rent	This is for retail leases only and what is the natural breakpoint and percentage?
8. Rent Escalation	How are base rents escalated, an index like CPI, fixed increases, or flat rent?
9. CAM	Retail leases only and what costs are included?
10. Type of Lease	Are leases gross or full service, double net or triple net?
11. Expense Reimbursements	Depends on whether the leases are gross, net, base year or have an expense stop.
12. Inflation Rate	What is the inflation rate for the proforma?
13. Terminal Value Cap Rate	Should be the same as the going-in or acquisition cap rate.
14. Management Fee	What is the annual property management fee?
15. Discount Rate	The discount rate should be the risk-free rate plus a CRE risk premium (today it is typically 8% to 10%).

The above general underwriting assumptions are critical to the preparation of an investment proforma. Although in practice, most acquisition proformas are never close to actual experience, it is still a critical CRE investment process and exercise.

Strategy and Insight for the Commercial Real Estate Industry

A Publication of Paramount Capital Corporation

Developing a CRE Investment Strategy for the 2024/25 Boom

The current downturn in the CRE industry since the Federal Reserve began raising interest rates is coming to an end and many firms that have been inactive and basically treading water need to develop a new CRE investment strategy to take advantage of the opportunities that will be available in the next few years. One of the most important issues of investing in CRE is the investment strategy and in the next few years, the most viable and profitable strategies will be to increase risk and acquire opportunistic and distressed real estate investments and develop new projects. Opportunistic property deals will be available in office and apartments that are over-leveraged and need substantial releasing and tenanting or capital improvements to increase value. Distressed properties, primarily office, in the high-crime urban markets will be available to purchase at deep discounts of 40%-50% and there will be a plethora of defaulted and foreclosure loan sales at 20%-30% discounts from the loans par value.

There are six established CRE institutional investment strategies from the most conservative and lowest return to the riskiest but highest return; core, core plus, value-added, opportunistic, distressed and development. We believe that investors should concentrate on the last three strategies as these will yield the highest return albeit have the highest risk. To be successful in investing in this mini-boom investors must also decide on the property type, geographic location, and investment structure. The highest return will derive from the most out-of-favor assets like office and apartments in high-crime urban locales. The investment structure is critical and can be in a limited partnership fund, special account, joint venture, commingled fund, REIT, or one-off deals. All of these strategies are critical to achieving success in the mini-boom and operation of a CRE investment organization. The three investment strategies discussed above are further explained as follows:

I. Opportunistic Investments

A high-risk-high-reward investment strategy wherein investors pursue properties that need a significant amount of renovation, have high vacancies, are functionally obsolete, have a higher and better use or face changes in demand in the local market. These investments require

Strategy and Insight for the Commercial Real Estate Industry

A Publication of Paramount Capital Corporation

considerable time and work and therefore are some of the highest risk and yield the greatest returns. Typical investments are held for 3-7 years, to achieve a 15%-20%+ IRR on the equity.

II. Distressed Investments

This investment strategy produces high risk and reward and involves counter-cyclical investments in CRE assets as well as defaulted loans and property bankruptcies. The distressed investor is typically active in economic downturns or recessions and seeks to buy CRE assets at deep discounts of fifty cents on the dollar or acquire defaulted loans at a similar discount with the objective of foreclosing on the loan to obtain the equity interest. Typical investments are held for 2-5 years and can generate IRRs on the equity from 15%-25%+.

III. New Development

The last investment strategy carries the highest risk and return and involves the construction of new CRE properties. Development is risky because of the length of time to complete a new project (typically 2-3 years), changes in market demand and interest rates during construction, loss of prospective tenants during construction and leasing of the project upon completion. The cap rate (stabilized net operating income divided by the total development cost) on development projects is usually 1%-2% higher than that of the same property acquired fully leased. IRRs on the equity for development deals are typically in the 15%-25%+ range.