View of the Market

Volume XVI/Issue 5/May 2024

Strategy and Insight for the Commercial Real Estate Industry

A Publication of Paramount Capital Corporation

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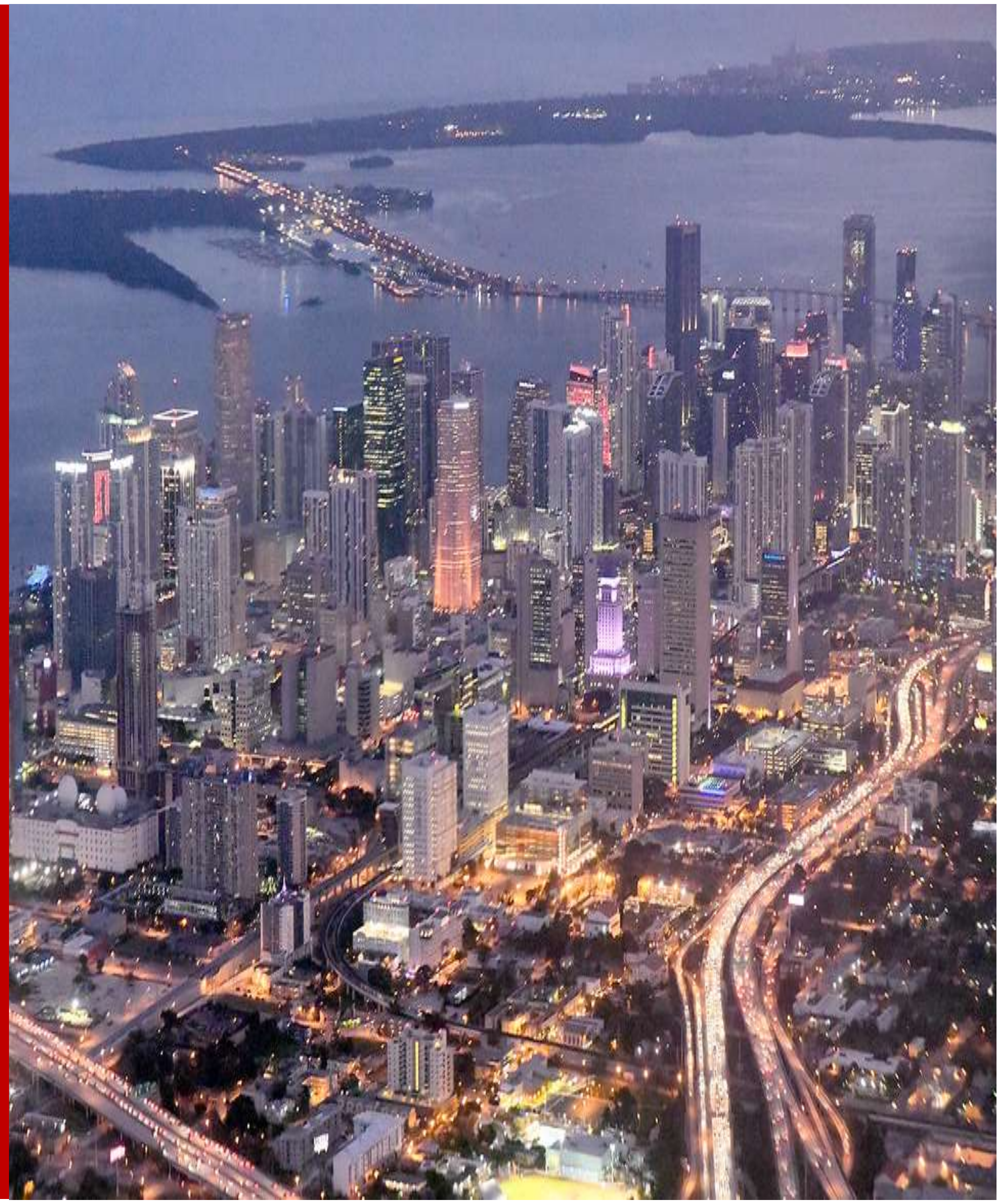

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REAL STATE FOCUS

A Review of the Apartment Market

The apartment market has been one of the best-performing sectors of CRE market until the Federal Reserve began raising interest rates in March 2020. Before this date and since the end of the Great Recession in 2012 the apartment market boomed, with compressed cap rates, high single-digit rent increases in the "hot markets" and construction of more than 350,000 units each year. Beginning in 2015, cap rates for new Class A apartments in the Sunbelt, Silicon Valley and other high-growth markets compressed from about 5.0%-7.0%+ to 3.5%-5:5%+. Average rents for the same period in the growth markets increased approximately 5.0%-7.0%+ per annum. New construction for the same period averaged over 355,000 units per year per MBA.org. However, since the Fed began raising rates, cap rates have expanded to 6.0%-8.0%+, and average national rents have increased only 3.0% during this period, but apartment construction is still on steroids with 644,000 new units completed as of February 2024. Key statistics and data on the apartment market are discussed below.

I. Key Statistics

General statistics for the apartment market as of Q1 2024 per broker, Cushman & Wakefield are as follows:

- Vacancy rate – 8.7%
- Net absorption – 85,921 units
- Average monthly rent - $1,823 (up 1.5% YoY)
- Construction starts – 762,858 units

II. Pros and Cons of Apartment Investment

The apartment market is a favorite for various investor groups and the pros and cons of apartment investment include the following:

- Pros
  - Easy to understand, analyze and underwrite
  - Easy to finance (Fannie Mae and Freddie Mac finance about 58% or $150B of all apartment loans)
  - Favorable financing rates and terms
  - Strong demographics with an increase in renters in all age groups
  - Investment type diversity including Class A, B & C, suburban, urban, garden, hi-rise, low-income and low-income tax credit properties
  - Range of values and cap rates available
  - Lower financial volatility with hundreds of tenants and no tenant concentration as opposed to commercial property types
  - Easier to develop with most communities supporting new apartments, especially those with low-income units

- Cons
  - Management intensive with hundreds of units and tenants
  - Older properties need significant upgrades and renovation
  - Beware of "hi-beta" markets like; Atlanta, Austin, Charlotte, Dallas, Denver, Houston, Phoenix, Orlando, Tampa, and Las Vegas, which consistently go through "boom and bust" cycles due to few development controls and ample vacant land
  - High fixed costs
  - High unit turnover and costs in many markets

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III. Apartment Rental Rates and Rent Growth

Apartment rental rates have risen at low single-digit rates in many markets, especially in the high-growth Sunbelt and large urban markets. However, these markets realized 5.0%-10%+ annual rental rate increases from 2018 to 2022. The chart below shows the average rent and rent change for ten key markets per the Cushman & Wakefield report for Q1 2024.

City	Monthly Rent	YoY Rent Change
San Francisco, CA	$3,327	1.8%
New York, NY	$3,116	2.6%
Los Angeles, CA	$2,598	0.4%
Washington D.C.	$2,170	3.9%
Austin, TX	$1,588	-4.6%
Miami	$2,471	3.0%
Las Vegas	$1,467	1.0%
Phoenix	$1,585	-0.8%
Charlotte	$1,563	-1.0%
Nashville	$1,649	0.0%

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The chart below per Cushman & Wakefield shows slowing rent growth and higher vacancy due to the large number of new units being built in most major markets around the country.

IV. New Apartment Construction

The chart below shows new apartment permits and completions for new apartment construction per the Mortgage Bankers Association. This period of annual construction of more than 300,000 units per year is projected to continue for at least the next five years.

Period	Permits	Completions
2019	481,000	343,000
2020	445,000	365,000
2021	569,000	364,000

2022	635,000	359,000
2023	509,000	438,000
2024 (2/24)	429,000	644,000

V. Apartment Returns

The yearly returns including price change and dividends for apartments per both NAREIT and NCREIF are shown in the two charts below. The NCREIF returns are not leveraged and since apartments are the most leveraged at 65%-70+% of value, the levered returns for apartments would be more than twice the returns shown.

NAREIT	3/24	2023	2022	2021	2020
Annual Return	-5.29%	5.87%	-31.95%	63.61%	-14.34%

Data per NAREIT

Property Type	NCREIF NPI Annual Returns			
	1 Year(Q3 2023)	5 Years	10 Years	20 Years
Apartments	-5.1%	6.6%	7.7%	8.0%

Data per NCREIF national property index

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The Largest CRE Private Equity Firms

There are hundreds of CRE private equity firms in the U.S. and below are the firms that raised the most amount of funds during the last five years through 2023. As shown, just the 15 largest firms raised over $244 billion during the last five years and there is a lot of dry powder to invest in CRE in the U.S.

Firm	Five Year Fundraising Total (billions	Location
1. Blackstone	$48.7	New York
2. Brookfield Asset Management	$29.9	Toronto
3. Starwood Capital Group	$21.7	Miami
4. The Carlyle Group	$14.8	Washington DC
5. BentallGreenOak	$14.7	New York
6. AEW	$13.4	Boston
7. Cerberus Capital Management	$13.0	New York
8. ARES Management	$12.9	Los Angeles
9. Rockpoint Group	$11.2	Boston
10. Bridge Investment Group	$11.2	Salt Lake City
11. Tishman Speyer	$11.2	New York
12. Pretium Partners	$11.0	New York
13. KKR	$10.9	New York
14. Angelo Gordon	$10.0	New York
15. Apollo Global Management	$9.7	New York
Total	$244.3	

Source: prenews.com

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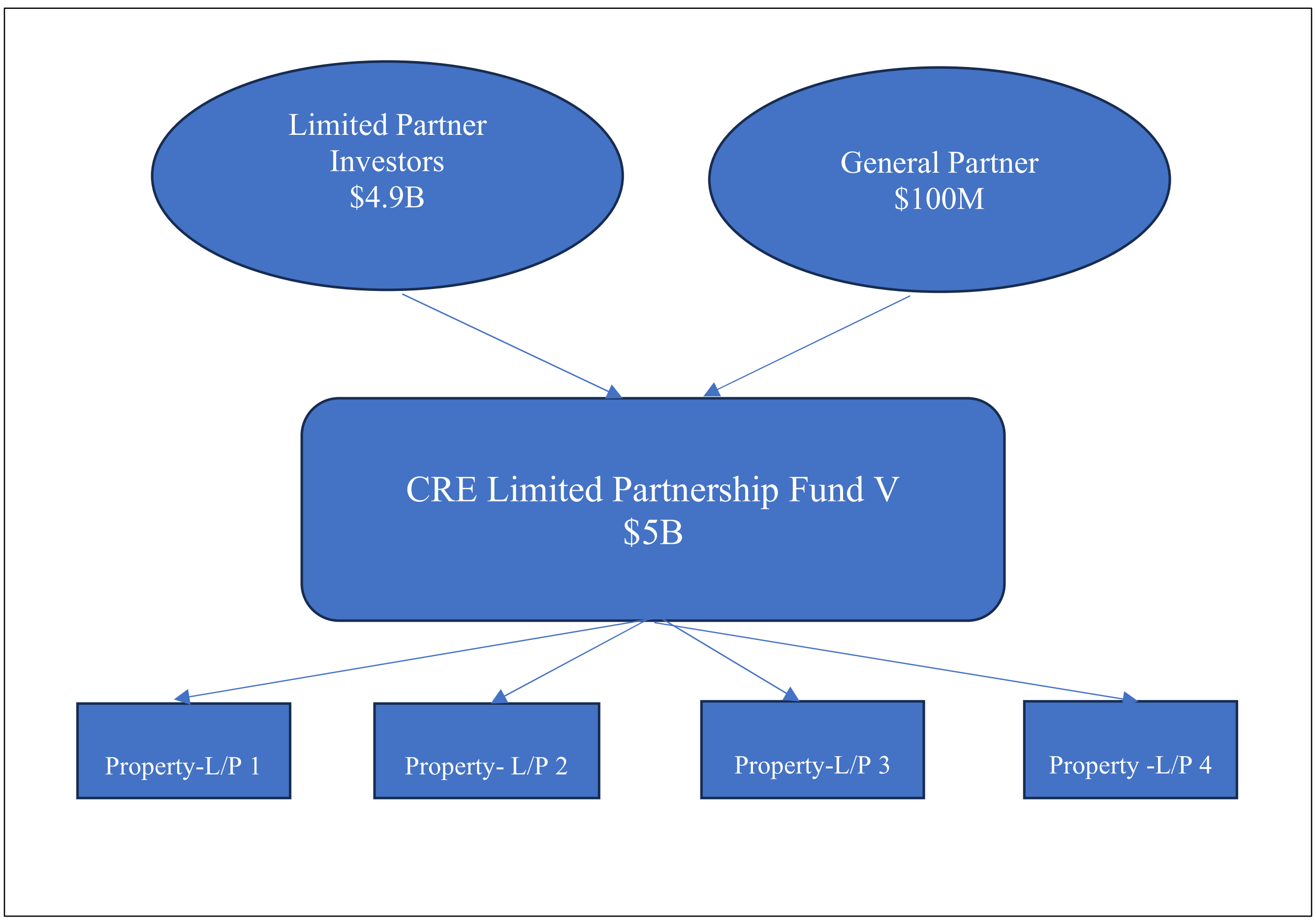
The Structure of a CRE Private Equity Fund

The corporate structure of a private equity commercial real estate fund is diagramed below. In this example, the private equity fund has raised $5 billion for its fifth CRE private equity fund. The fund will invest in value-added and opportunistic CRE assets including office, apartments, retail, industrial, hotel and data centers. The fund will not invest in land, senior housing, and new construction. Approximately 70% of the investments will be in the high-growth low-tax Sunbelt states and no funds will be invested in Urban Markets characterized by high crime rates and outmigration of residents and companies.



The fund will use leverage up to 65% of cost and is seeking to generate an internal rate of return on the limited partner equity of between 15% and 20% over a seven-year holding period. The general partner will invest $100 million of the equity and receive a 2.0% asset management fee of the limited partner's equity paid annually and a carried interest of 20.0%. The limited partners will invest $4.9 billion of the equity and receive an ownership interest of 80% and an annual preferred return on their unreturned capital of 7.0%. The general partner will also receive the 7.0% preferred return on its $100 million of invested capital.

The fund will invest in completed real estate properties and each property will be owned by a separate bankruptcy remote limited partnership (or limited liability company depending on the state). Each property will be levered with a first mortgage of up to 65% of the purchase price. An affiliate of the general partner will also manage each property for an annual management fee of 6.0% of the effective gross income of each property. An affiliate of the general partner will also receive a sale brokerage fee of 3.0% upon the sale of a property and will pay third-party brokerage firms up to 2.5% of this fee for advising on the sale.

The waterfall for cash distributions and capital events is first, the preferred return to the limited partners and general partner, then, the limited partner's capital, then the general partner's capital, then any remaining cash flow or capital proceeds 80% to the limited partners and 20% to the general partner.

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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 40 years in the CRE industry. Mr. Ori lists essential dos and don'ts, mistakes, and successful strategies with a mixture of critical analysis and a keen sense of satirical humor, reinforced by his encyclopedic knowledge of the commercial real estate environment. Mr. Ori covers all areas of the industry. Commercial real estate investment, finance, development, capital markets, and management tactics are all given his full attention, as are leasing, financial analysis, and institutional investments. He applies his commandments to all property types, including apartments, office buildings, shopping centers, industrial warehouses, lodging properties, and senior housing.

Commercial Real Estate Investment for Pros (and Dummies Too!) discusses the history, the various financial players, legal and financial structures, property types, modern portfolio theory and the financial metrics of commercial real estate investment and the commercial real estate industry. The book includes numerous charts and analyses of the industry and a step-by-step breakdown of the commercial real estate analysis and investment process. The book is perfect reading for the experienced real estate pro and also understandable to the real estate novice or someone new to the industry.

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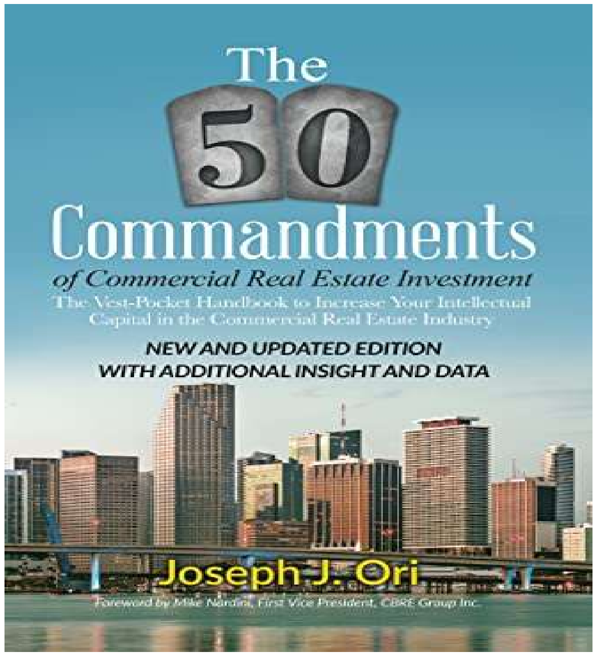

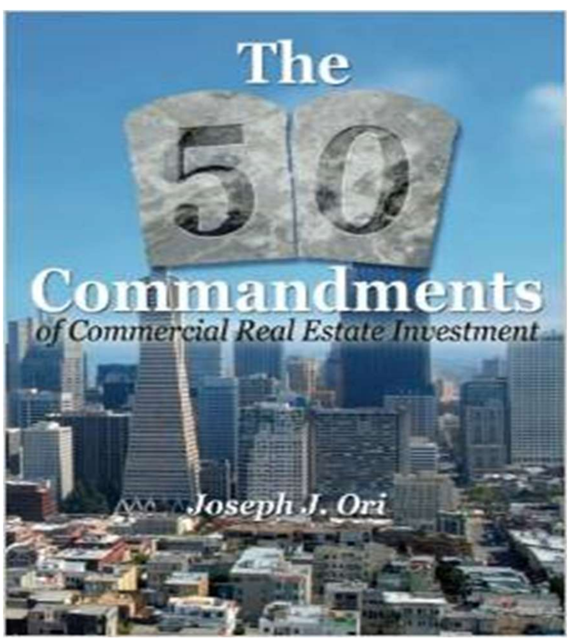

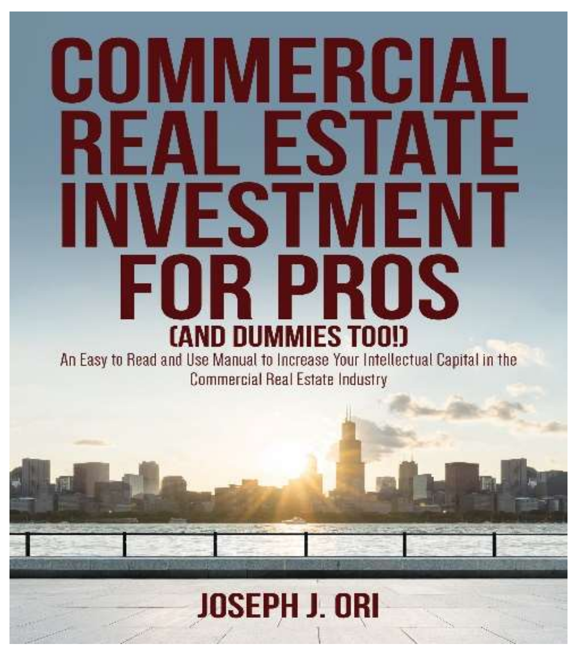

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CRE Financing Rates

Loan Type	Mortgage Rate	Maximum Amortization	Term (years)	Maximum LTV
Permanent Loans	5.87%-10.50%+	30	10	70%
Conduit-CMBS	5.88%-7.49%+	30	10	70%
Bridge Loans	6.50%-14.50%+	Interest Only	1-3	80%
Construction Loans	10.00%-15.00%+	Interest Only	1-4	70%
Insurance Co. Loans	5.38%-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 SOFR (secured overnight funding rate)	5.32%
1 Year Swap	5.07%
10 Year Swap	4.12%
5 Year Treasury	4.57%
10 Year Treasury	4.57%
Federal Funds Rate	5.25%

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Short-term interest rates have remained stable with the 30-day SOFR rate at 5.32%, however, the ten-year treasury rate has increased to 4.57%. The Federal Reserve met on March 19-20, 2024, and kept the funds rate at 5.25%. We still believe that the Fed will begin to lower rates in the second quarter of 2024, which will create a mini-boom in CRE. 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.

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CRE Deal Focus

CRE Deals of the Month

Purchaser/ Sponsor	Seller	Property/ Deal	Price	Description
Blackstone Fund	Apartment Income REIT Corp.	Public REIT with 76 Apartment Properties	$10B	Blackstone is taking the REIT private at $39/sh.
Sunstone Hotel Investors, Inc.	Hyatt Corporation	Hyatt Regency Hotel, San Antonio, TX	$230M	A 630-room Hyatt hotel.
AEW Capital Management	Decron Properties	Ranch at Moorpark, Moorpark, CA	$133M	A 376-unit apartment property built in 1997.
Stonepeak	CenterPoint Properties	Industrial Portfolio, Elwood, IL	$125M	A three-building industrial portfolio with 1.7 million square feet.

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David Werner	Barings	100 Wall St., New York, NY	$115M	A 516,74-square foot office building.
Peris Corp	Walgreens	Industrial Property, Moreno Valley, CA	$111M	Sale-leaseback of a 692,600 square-foot industrial building leased by Walgreens.
W.P. Carey	Van Trust Real Estate	Rickenbacker Exchange Building, Commercial Point, OH	$94M	A 1.19 million square foot industrial building built in 2022.
Primestor Development	DRA Advisors	Esplanade Shopping Center, Oxnard, CA	$90M	A 357,000-square-foot shopping center.
Eaton Vance Real Estate Group	Scannell Properties	Performance Food Group at Cardinal North, Glen Allen, VA	$85M	A 328,335-square-foot cold storage building fully leased to Performance Food Group.

Black Lion	Clarion Partners	Lincoln Office/Retail Building, Miami Beach, FL	$62M	A 118,658-square foot office/retail building.

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 profound 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. Systematic Innovation

Successful entrepreneurs do not wait until "the Muse kisses them" and gives them a bright idea: they go to work. Systematic innovation means monitoring seven sources of innovative opportunity. The first four sources lie within the enterprise, whether business or public-service institution or within an industry or service sector. The second set of sources for innovative opportunity involves changes outside the enterprise or industry. Monitor the seven windows of innovative opportunity; the unexpected; the incongruity; process need; changes in industry structure or market structure; changes in demographics; changes in perception, mood and meaning and new knowledge.

II. Unexpected Success

It takes an effort to perceive unexpected success as one’s own best opportunity. It is precisely because the unexpected jolts us out of our preconceived notions, our assumptions, our certainties, that it is such a fertile source of innovation. In no other area are innovative opportunities less risky and their pursuit less arduous. Yet the unexpected success is almost totally neglected; worse, management tends to actively reject it. One reason why it is difficult for management to accept unexpected success is that all of us tend to believe that anything that has lasted a fair amount of time must be “normal” and go on “forever.”

III. Unexpected Failure

Failure should always be considered a symptom of an innovative opportunity. The unexpected failure demands that you go out, look around, and listen. A competitor’s unexpected success or failure is equally important. Unexpected failure often informs us of underlying changes in customer values and perceptions. Identify an important unexpected failure, yours, or a competitor's. Identify plausible explanations for the failure. Apply these lessons to your current business.

IV. Incongruity

The incongruity bespeaks and underlying “fault.” There is often a discrepancy between “what is” and what management thinks “ought to be” that represents an incongruity within an industry, a market, and a process. The incongruity may be clearly visible to the people within or close to the industry, market, or process. Insiders may notice it but think “this is the way it has always been,” as a reason for not initiating a change. Change leaders exploit these incongruities to the organization’s advantage.

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The Dividend Discount Model and the Cap Rate

In corporate finance, the dividend discount model (DDM) is used to calculate the value of a common stock. It is based on discounting future dividends to arrive at the price of a common stock today. The calculations in the DDM use per-share amounts and not dollars. The financial model is as follows; D+1/R-G, wherein, D+1 is next year's dividend per share, R is the expected return on the stock in the next year and G is the growth rate of the dividend. If a company has a current dividend of $10/sh., that is growing by 5.0% per year and the expected return on the stock is 12.0%, then the formula would be $10x1.05/12%-5% or $150 per share. Therefore, the estimated value of the stock in one year is $150/sh. Notice that the formula does not include a future stock price in the calculation. This is because the formula assumes that the dividend will increase into perpetuity at the 5.0% growth rate and the present value of the stock will at any point in the future be the then dividend divided by the expected return (12.0%) less the dividend growth rate (5.0%). The DDM formula can also be rearranged to solve for R, or the expected return on the stock as follows: R=(D/P) + G. This return is equal to the discount rate from the cap rate formula as used in CRE and discussed below.

Long-time readers of this newsletter know that the value of a property is next year's net operating income (NOI) divided by the cap rate. If the NOI is $1,000,000 and the cap rate is 5.0%, then the value of the property is $20,000,000 ($1,000,000/5.0%). The cap rate can be written as a formula as follows; Risk-Free Rate (10-year Treasury) plus a Risk Premium (typically between 3.0%-10.0%) less the Growth Rate in Income (estimated at 3.0%). Using a ten-year treasury rate of 4.40%, a risk premium of 7.0% and a growth rate of 3.0%, the cap rate is 8.40% (4.40%+7.0%-3.0%). This is an average cap rate and would need further adjustment for the property type and location. If the property is an industrial building in Miami, FL, the risk premium would be 4.0% and the growth rate in income would be 3.0%, which yields a cap rate of 5.40% (4.40%+4.0%-3.0%). The first part of the cap rate formula of the Risk-Free Rate plus a Risk Premium is the discount rate used to discount annual NOIs and arrive at a net present value of the property.

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How is the dividend discount model related to the cap rate? Well, they are basically the same formula, with the DDM using per-share amounts and the cap rate formula using dollars. The denominator in the DDM of R-G is the cap rate and R would be the risk-free rate plus a risk premium and G would be the growth rate of the property's income. If the NOI is substituted for the dividend in the DDM above, then the value would be $14,285,000 ($1,000,000/12.0%-5.0%). The value of R in the DDM is (D/P) + G and is equivalent to (NOI/P) + G. And as stated above, the discount rate is used to discount annual cash flows or NOIs to arrive at the company or property net present value.

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REIT Statistics

Current REIT statistics for 2/29/24 per NAREIT are included in the table below. Please note that the all-equity REIT return over 20 years includes three CRE downturns, the Great Recession, the retail and store closure meltdown and the current higher interest rate regime.

Period	***All REITs***	***All Equity REITs***	***S&P 500***	***NASDAQ Composite***
2/2024	-3.14%	-3.03%	7.11%	**7.33%**
1-Year	4.20%	4.29%	30.45%	**41.63%**
5-Year	4.02%	4.50%	14.76%	**17.38%**
10-Year	6.50%	6.78%	12.70%	**15.23%**
20-Year	7.21%	7.79%	9.90%	**10.91%**
Market Capitalization	$1.32T	$1.26T	$43.7T	$19.0T
Dividend Yield	4.38%	4.04%	1.34%	1.46%

REIT Review

Summary

This REIT valuation is on Urban Edge Properties, ("UE"), a publicly-traded REIT that is engaged in owning, managing, acquiring, developing, and redeveloping retail real estate in urban communities. UEs properties are primarily located in the Washington, D.C. to Boston corridor. UE owns 71 properties with 17.1 million square feet that are 96% leased. The three largest tenants are; TJ Maxx (5.5% of annualized base rent), Home Depot (4.2% of annualized base rent) and Kohls (3.1% of annualized base rent). The same store net operating income growth for Q1-24 YoY was 6.2%.

Property Developments

As of Q1-24, UE was redeveloping more than twelve properties with a total cost of $168.1 million with $55.9 million incurred through 12/31/23.

Corporate Data

UE is traded on the NYSE, is incorporated in Maryland, and is located in New York, NY. UE has 118.8 million common shares outstanding and a market capitalization of approximately $2,170 billion. UE owns a 94.8% interest in its UpREIT partnership, Urban Edge Properties L.P.

Management

Jeffrey S. Olson, 56, Chairman and CEO

Mr. Olson joined Urban Edge Properties as Chairman and Chief Executive Officer when the company spun from Vornado Realty Trust in 2015. Mr. Olson served as Chief Executive Officer of Equity One, Inc. from 2006 to 2014. He was President of the Eastern and Western Regions of Kimco Realty Corporation from 2002 to 2006. Mr. Olson has a Bachelor of Science in Accounting from the University of Maryland, a Master of Science in Real Estate from The Johns Hopkins University and was previously a Certified Public Accountant. Mr. Olson is a Board Member of the National Association of Real Estate Investment Trusts and is Chairman of the Real Estate Advisory Board at The Johns Hopkins University.

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Ownership

Top Institutional Holders	Shares (000's)	%
Blackrock, Inc.	21,490	18.10
The Vanguard Group, Inc.	18,360	15.46
FMR LLC	13,090	11.02
State Street Corporation	7,410	6.24
Resolution Capital Ltd.	4,480	3.78

Ownership Breakdown	
% Of Shares Held by All Insiders and 5% Owners	.12
% Of Shares Held by Institutional & Mutual Fund Owners	97.91
Number of Institutions Holding Shares	339

All amounts above per Yahoo Finance

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Financial Analysis and Valuation

Select financial data for UE per the 2024 Q1 10Q and supplemental information.

(In millions where applicable)

Financial Data	Amounts
Real Estate Assets, Gross	$3,602
Total Assets	$3,241
Property Debt (at weighted average interest rates of approximately 5.0%)	$1,678
Stockholders' Equity	$1,222
Revenue	$109
Net Income (Loss)	$2
Cash Flow from Operations	$22
Unsecured Credit Facility ($800M with $153M used)	$647
Market Capitalization	$2,170
Property Debt to:	
Gross Real Estate Assets	46%
Market Capitalization	77%
Enterprise Value	44%
Dividend and Yield ($.68/sh.)	3.98%
Shares Sold Short (in millions per Yahoo Finance)	4,400

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Valuation Methodology	
Q1-24 Real Estate Revenue	$109
Q1-24 Real Estate Operating Expenses (excluding depreciation, amortization, interest expense, impairment charges plus G&A expenses)	$41
Q1-24 Net Operating Income	$68
Proforma Annualized Net Operating Income at 102%	$277
Projected Average Cap Rate	7.5%
Projected Value of Real Estate Assets	$3,693
Add: Net Operating Working Capital (at book value)	$137
Construction in Progress (at book value)	$254
Total Projected Value of the Assets of the Company	$4,084
Less: Total Debt per Above	($1,678)
Projected Net Asset Value of the Company	$2,406
Common Shares Outstanding, 118.8M	
Projected NAV Per Share	**$20**
Market Price Per Share on 5/15/24	**$17**
Premium (Discount) to NAV	**(15%)**

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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 UE for the years 2019 through Q1-24 are shown in the table below.

(Millions except dividend and per share amounts)	2019	2020	2021	2022	2023	Q1-24
Gross Real Estate Assets	$2,748	$2,946	$3,205	$3,326	$3,586	$3,602
Property Debt	$1,546	$1,587	$1,687	$1,691	$1,731	$1,678
Revenues	$387	$330	$425	$397	$416	$109
Net Income (Loss)	$109	$93	$102	$46	$248	$2
Funds from Operations (FFO)	$167	$156	$180	$145	$184	$198
Return on Invested Capital (1)	9.0%	7.1%	7.0%	7.30%	10.0%	NA
Dividend Coverage (2)	1.50	1.87	1.40	1.85	2.36	1.59
Dividends Paid Per Share	$.21	$.67	$.15	$.16	$.16	$.17

(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 in 2024 is $.17 per quarter.

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

UE Total Return	1/2024	1-Yr	3-yr	5-Yr
	-7.05%	14.95%	4.87%	1.56%

As shown above, our net asset value per share for UE is $20/sh., compared to a market price of $17/sh. Current average cap rates for retail properties per our industry experience and CBRE's Cap Rate Survey are in the 6.0% to 9.0% range, depending on the location and quality of the property. We have used an average cap rate of 7.5% due to UEs diversified portfolio of retail properties.

Strengths:

- The stock is trading at a 15% discount to our NAV.

Concerns:

- REIT prices will decline if interest rates increase.
- A low dividend yield of 3.98%.
- The majority of UEs portfolio is concentrated in the Washington, D.C. to Boston, MA corridor.
- UE has only one property in the high-growth, low-tax Sunbelt states.

Recommendation:

UE is trading at a discount of 15% to our NAV per share, however, we are not recommending the purchase of the stock.

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

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

1. Hudson Pacific Properties, Inc., August 2022
2. Kilroy Realty Corporation, September 2022
3. Realty Income Corporation, October 2022
4. Federal Realty Trust, November 2022
5. Equity Residential, December 2022
6. STAG Industrial, January 2023
7. Brixmor Property Group, Inc., February 2023
8. Mid-America Apartment Communities, March 2023
9. Office Properties, Trust, April 2023
10. Spirit Realty Capital, Inc., May 2023
11. Cousins Properties, Inc., June 2023
12. Tanger Factory Outlet Centers, Inc., July 2023
13. Paramount Group, Inc., August 2023
14. Broadstone Net Lease, Inc., September 2023
15. Apartment Income REIT Corp., October 2023

16. Kite Realty Group Trust, November 2023
17. Alexandria Real Estate Equities, Inc., December 2023
18. Agree Realty Corporation, January 2024
19. WP Carey, February 2024
20. Essex Property Trust, March 2024
21. Brandywine Realty Trust, April 2024

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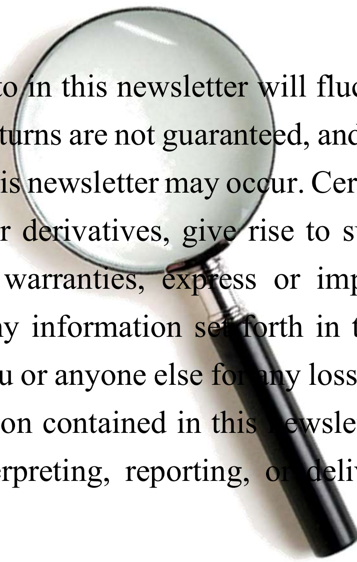

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