

# QUARTERLY UPDATE

## CWS CAPITAL PARTNERS LLC

CWS Capital Partners LLC

# CWS

### CALENDAR OF EVENTS

March 15, 2024

Year 2023 K-1

Target Mail by Date

March 29, 2024

Good Friday Holiday

CWS Offices Closed

April 15, 2024

2023 Federal/State Tax Filing Deadline

1<sup>st</sup> Quarter 2024 Est. Payments Due

April 26, 2024

1<sup>st</sup> Quarter 2024

Quarterly Reports & Distributions Delivery

May 27, 2024

Memorial Day Holiday

CWS Offices Closed

June 17, 2024

2<sup>nd</sup> Quarter 2024 Est. Tax Payments Due

July 4, 2024

Independence Day Holiday

CWS Offices Closed

July 26, 2024

2<sup>nd</sup> Quarter 2024

Quarterly Reports & Distributions Delivery

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## CAP RELIEF: A POWERFUL INFLECTION POINT



By Gary Carmell

All roads lead to the cost of interest rate caps for many of our CWS properties. I say this because we have a number of variable-rate loans with caps that are lower than prevailing interest rates. As a result, the projected drop in short-term interest rates that is expected to take place in 2024 will not have a meaningful impact on debt service for these properties unless rates drop below the strike rate of the cap.

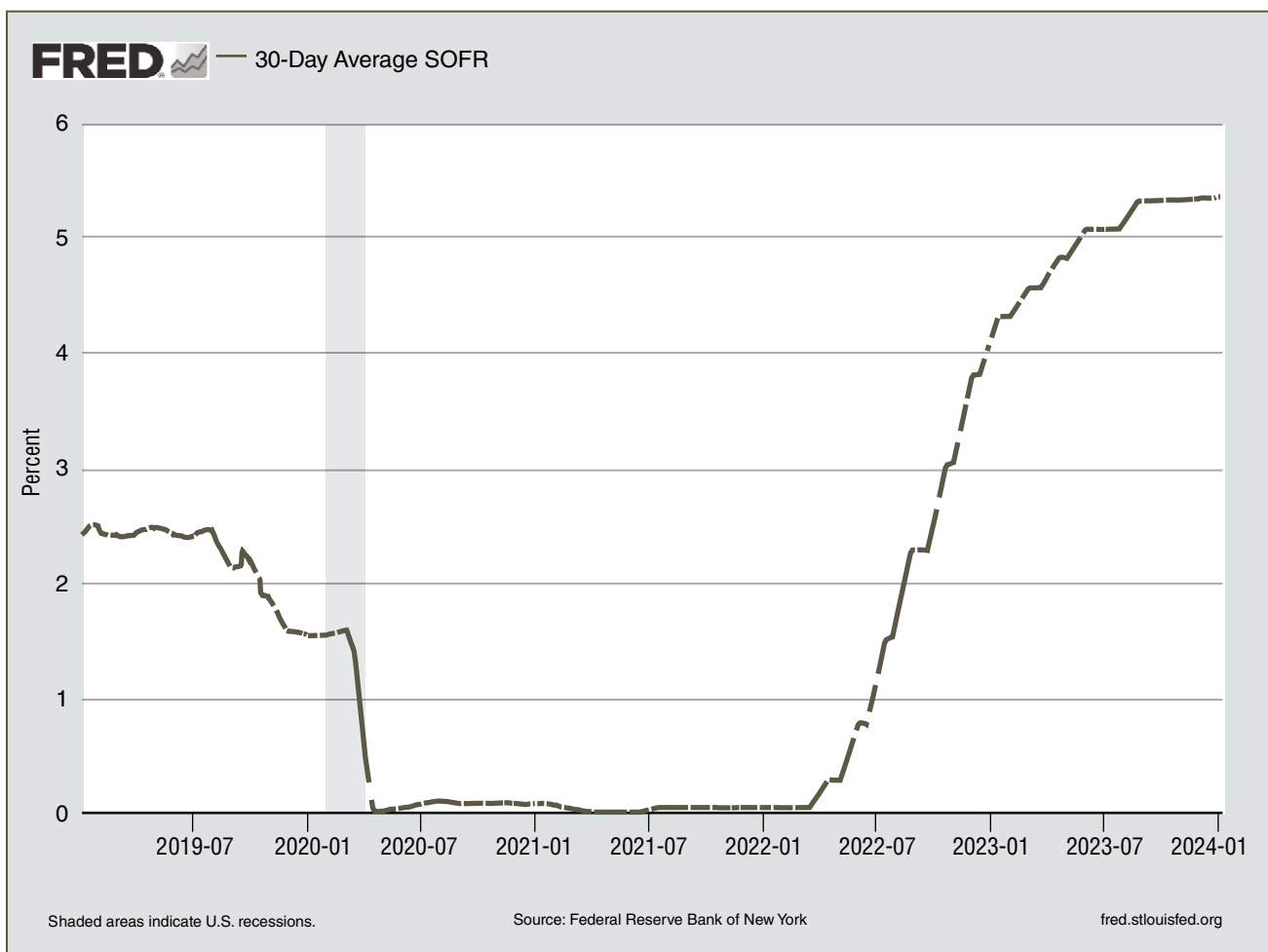
It's often easier to explain something through an example than through language. I will use a property we own in the Denver area as an example throughout this article. We recently had to purchase a new two-year interest rate cap since the previous one expired. The strike rate is 4.10% based on 30-day SOFR. Right now, SOFR is at approximately 5.46%. Given this, the interest rate cap is "in the money" because the strike rate is lower than the index. As a result, the property will receive payments monthly during the life of the cap as long as this continues to be

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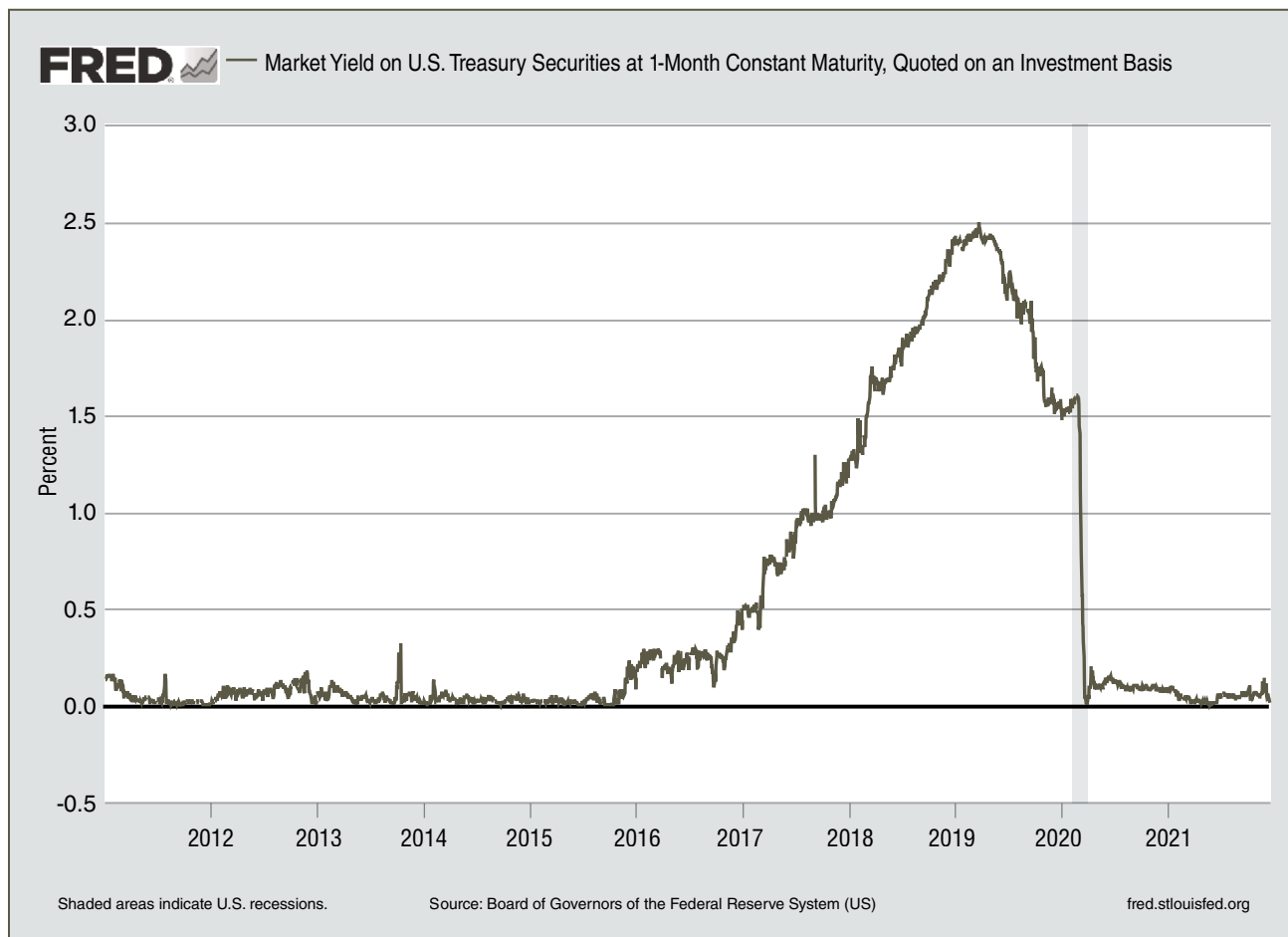
the case. On the other hand, if rates drop, then the interest paid to the lender will drop, but so will the payments received from the cap seller such that they cancel each other out. And if SOFR drops below 4.10%, then we will no longer receive any payments from the cap seller but will continue to pay less in interest to the property lender.

SOFR replaced LIBOR as the standard index for variable-rate loans relatively recently so there's not a lot of history for this index. This graph does show how during Covid SOFR fell close to 0% and then shot up far higher and faster than most people projected beginning in April 2022 when the Fed first raised rates in this cycle.



To provide a longer-term perspective of short-term rates, this is the yield on the 30-day T-Bill from 2011 through 2021. I chose this time frame because we started using floating-rate debt much more beginning in 2011. It's also a good proxy for 30-day LIBOR, which was the index our variable-rate loans were tied to.

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One can see how low short-term interest rates were during this time frame. They peaked at approximately 2.50%. The average rate for this period was 0.52%, and when you add our typical spread over the index our average interest rate was approximately 2.35% during this period. This was a very profitable strategy for us, particularly given the prepayment flexibility associated with floating-rate loans, as we were able to repay approximately \$2.7 billion of floating-rate debt prior to maturity between 2013 and 2023, which allowed us to sell properties without requiring purchasers to assume fixed-rate loans that had high prepayment penalties. It also enabled us to refinance into new loans with lower spreads, more term, longer interest-only periods, and often more proceeds. It also benefited us by providing the ability to purchase very cheap interest rate protection because the cost of “out of the money” interest rate caps, in which strike rates were much higher than projected future rates, was so low. This was understandable because rates had stayed low for a very long period and were expected to continue to do so. Everything changed, however, with the Covid lockdowns which unleashed

enormous fiscal support and huge monetary stimulus. When this was combined with the supply chain disruptions and labor dislocations, supply and demand became out of balance and inflation reared its ugly head.

Admittedly, because we were in the camp that believed rates would continue to stay low, when they inevitably did rise, we theorized they wouldn't go much beyond 3%. Obviously, we were wrong. This belief, however, led me to view cap purchases somewhat as wasted money because the likelihood of rates going higher than the strike rates at which we were purchasing them was minimal. It turned out that some of these caps became hugely valuable but also put us into challenging cash flow positions at some of our properties as the cost to replace expiring caps exploded and we needed to have enough funds reserved with our lenders to be able to purchase new ones. Let's return to our Denver property example.

The following table shows cap purchase information for the one we bought at purchase, the one we just purchased, the estimated value of the cap if we purchased it today, and based on the forward curve what it might cost 24 months from now when this current cap expires.

Cap Purchase Date	Strike Rate	Term	Cost	Payments/Est. Pmts.
Sept. 2020	3.50%	36 months	\$51,000	\$1,211,000
October 2023	4.10%	24 months	\$1,700,000	\$666,000*
Current Est. Cost			\$865,000**	
Future Estimated Cost in Oct. 2025			\$50,000***	

\*This includes the first two months of payments already received and 22 months of projected payments based on the forward curve as of 1/4/24.

\*\* Based on Chatham's cap calculator on 1/4/24.

\*\*\*Based on the forward curve as of 1/4/24. The average SOFR rate for 24 months starting in October 2025 is 3.22% based on the forward curve. Since the strike rate is 4.10%, which is higher than the average forward rate, theoretically the cap should have no value. Because this is only an estimate and other outcomes are possible (volatility) and the contracts have intrinsic time value until they expire, sellers of interest rate caps need to be compensated for exposing themselves to the risk of such variability. Given this, I randomly assigned a future value of \$50,000.

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One can see from the table how extraordinarily profitable the first cap we purchased was. We paid \$51,000 for it and it paid us \$1.2 million over its three-year life. And I thought it was pretty much a waste of money when we purchased it! Well, I shouldn't be that harsh on myself. The cost was actually minimal at the time so I had no issue with us buying the cap. Ahh but what God giveth he can taketh away.

One can see how when it came time to buy another cap that we purchased one for over 30 times the cost of the first one for a higher strike rate (4.10% versus 3.50%) and less term (two years versus three years). And with the big downward movement in rates, the market is now pricing in multiple Fed cuts which would lower the payments from the cap seller to us such that based on the current forward curve we would be net out of pocket \$1,034,000. Of course, we would also pay less in debt service to help cushion the blow. As an aside, if we continue to receive the same payments for the remaining 22 months of the cap as we have for the first two months, it would pay us \$1,881,000, which is higher than the cost of the cap, although the seller of the cap would have had the premium to invest, albeit a declining amount, over the term of the cap.

Where things get interesting is the projected cost of a cap in October 2025, when the current one expires. Every six months the lender calculates what the cost of a new cap would be and adds a 25% cushion to determine how much we should deposit every month into an impound account for a future rate cap purchase. Right now, we are impounding approximately \$78,000 per month. After 24 months this would result in us having approximately \$1.7 million in the account. This makes sense based on what we paid for the cap, but when factoring in current cap costs, we are impounding twice as much as we need to, and if the forward curve is anywhere close to being accurate, then we will be massively over collateralized when it comes time to purchase a new cap.

Like several of our other properties, we had to suspend distributions because, while we were massively benefiting from the cap we purchased initially, we had to plow back all those dollars, and then some, into the lender impound account to ensure we had enough funds to purchase the next cap. This necessitated a distribution suspension. Let's return to more numbers associated with this property.

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The following table uses the projected 2023 Net Operating Income and Capital Expenditures and carries them over to 2024 and 2025. The 2023 debt service is based on current rates annualized versus the actual 2023 debt service. The purpose of the table is to show how impactful cap costs have been, and are expected to be, on the cash flow of this investment.

	<b>2023</b>	<b>2024</b>	<b>2025</b>
Net Operating Income	5,822,000	5,822,000	5,822,000
Capital Expenditures	(465,000)	(465,000)	(465,000)
Operating Cash Flow	5,357,000	5,357,000	5,357,000
Debt Service*	(5,136,000)	(4,639,201)	(3,742,171)
Cash Flow Before Cap Effects	221,000	717,799	1,614,829
Cap Reimbursements	981,000	508,989	-
Cap Cost/Impounds	(1,700,000)	(860,000)	-
Net Cash Flow	(498,000)	366,788	1,614,829
Excess Impounds	N/A	N/A	810,000

\*2023 represents current rate annualized.

Based on the forward curve and projected cap pricing we go from generating negative \$500,000 cash flow in 2023 (this is actually an over-statement since debt service was less than what is shown in the table since it uses the annualized debt service based on the current rate) to a positive \$367,000 in 2024, to a much more flush \$1.6 million in 2025 along with excess impound dollars of approximately \$800,000. Of course, there are a lot of assumptions here and it's based on a forward curve that is fairly volatile and often wrong. On the other hand, if you do believe the Fed will start cutting rates in 2024 and 2025, then directionally this is a pretty good representation of how dramatic the swing in cash flow can be for some of our properties over the next couple of years.

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It also speaks to the importance of being patient as there really is light at the end of the tunnel as the Fed has acknowledged that rates have peaked so the next move will be down. And if the economy ends up weaker than expected, then it's possible that debt service may go even lower and cap costs continue dropping as rates come down more than is currently priced in.

I'm a big believer that one can learn a lot by doing a deep dive into a particular situation and draw out more widely applicable lessons. Fortunately, this Denver property had significant cash reserves and had the right amount of debt to have been able to manage through these challenging times without needing additional cash. Most of our properties are in a similar situation, although by all means not all.

We know for a number of our investors there has been some frustration felt due to distribution suspensions, drops, and/or capital calls. We never like taking any of those actions but we do it because we are playing the long game and will always make the difficult choice if it keeps us on the field versus the more expedient one that lessens the chance of us making it through the storm. I truly believe we are at an inflection point with the significant drop in cap costs that we can finally see the light and thread the needle to get from here to the other side.



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