Volume 37, No. 3, October 27, 2023

Quarterly Update
CWS Capital Partners LLC

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CWS

CALENDAR OF EVENTS

November 23-24, 2023
Thanksgiving Holiday
CWS Offices Closed

December 25, 2023
Christmas Holiday
CWS Offices Closed

January 1, 2024
New Year's Day Holiday
CWS Offices Closed

January 15, 2024
Martin Luther King Jr. Holiday
CWS Offices Closed

January 16, 2024
4th Quarter 2023
Est. Tax Payment Due

January 26, 2024
4th Quarter 2023
Quarterly Reports & Distributions

March 15, 2024
Year 2023 K-1s
Target Mail by Date

www.cwscapital.com

STRENGTHENING THE CWS PERMAFROST

By Gary Carmell

In late September five senior CWS executives huddled together for our annual get together to check in on our personal and professional lives and to put our heads together to help guide our strategy and resource allocation in the year ahead.

The meeting was held at Steve Sherwood's home in Deer Valley, Utah. It's a beautiful setting and very conducive to thinking more broadly as we're in high altitude with stunning views and very much out of our normal environment. We have been doing this for well over 20 years with a lot of great memories and some powerful insights that helped improve our decision making and overall success. And while I would like to say we have been infallible in having those meetings always translating to making better investments and avoiding poorly compensated risks, that has not always been the case. This is particularly so as the past year has resulted in having to face several challenges resulting from having a large percentage of variable-rate loans in a rapidly rising rate environment.

As I reflect on the many years we have met in Deer Valley, two experiences stand out for me that have a lot of applicability to the current environment impacting CWS. One of them was in 2002 which happened to be a meeting that included our advisory board members. I remember vividly showing some

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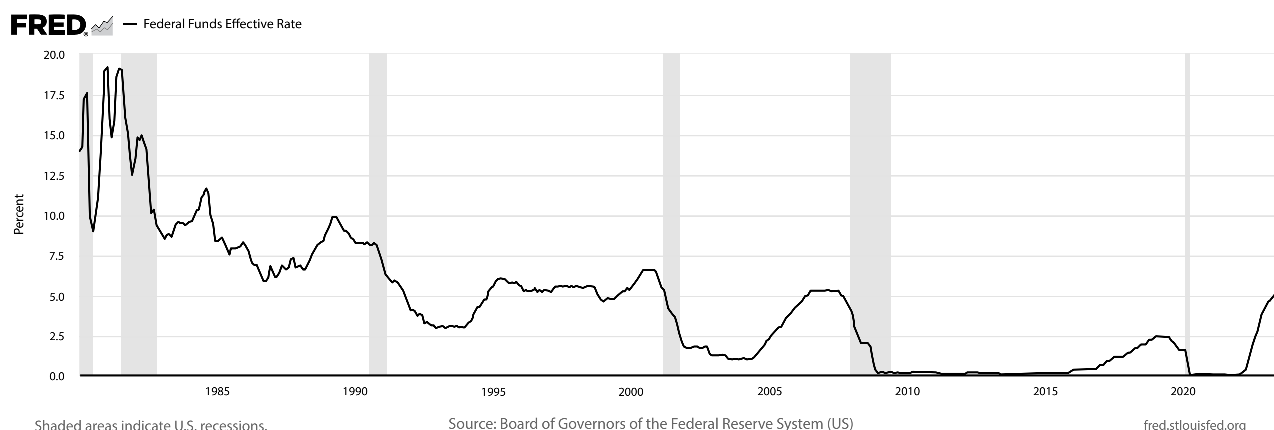
graphs of the explosive growth in residential mortgages and I was convinced this could not continue at such a blistering pace and that big problems were on the horizon. I didn't know when the bottom would fall out at the time but if I had to bet, I would have said within two years. It turns out that my sky is falling prognostication was early by approximately five years as the system only started to crack in 2007. The lesson here is that the reversal of powerful trends can take far longer to unfold. Interest rates dropped for approximately 40 years and during that time every year there was a chorus of experts and pundits who said that they were far too low and they could only go up. Eventually they were right as the Fed finally brought rates up in this cycle to a level that is higher than the previous peak. Until this time, as this chart shows, we benefitted greatly from our floating-rate exposure, and virtually every cyclical peak was lower than the previous one.



The second relevant experience I recall quite vividly because it took place on my birthday (June 29th), although I don't remember the year. When we started the meeting in the morning the weather was beautiful. The skies were pristine, and the sun was shining brightly. As the day went on , however, the weather slowly and methodically kept getting more overcast with dark clouds becoming more dominant. By early afternoon it started to snow and as the rest of the day unfolded a full-on blizzard materialized. I had never seen anything like it, nor have I since, and it was a sight to behold to witness such a dramatic change in a relatively short period of time, particularly at the end of June.

I bring this up because in some ways it serves as a very appropriate metaphor for what we have experienced since mid-2022 and continue to do so today.

I personally felt that we were well positioned to prosper during difficult times, particularly like we experienced in 2020 during Covid. The Fed brought rates down to 0% which lowered our debt service at a time when we were understandably concerned that our revenues were at severe risk of declining. Fortunately, much to our surprise, they not only held up well but accelerated at a pace we had never experienced before.

Recognizing that rates would most likely not stay at 0% forever and the cost of hedging

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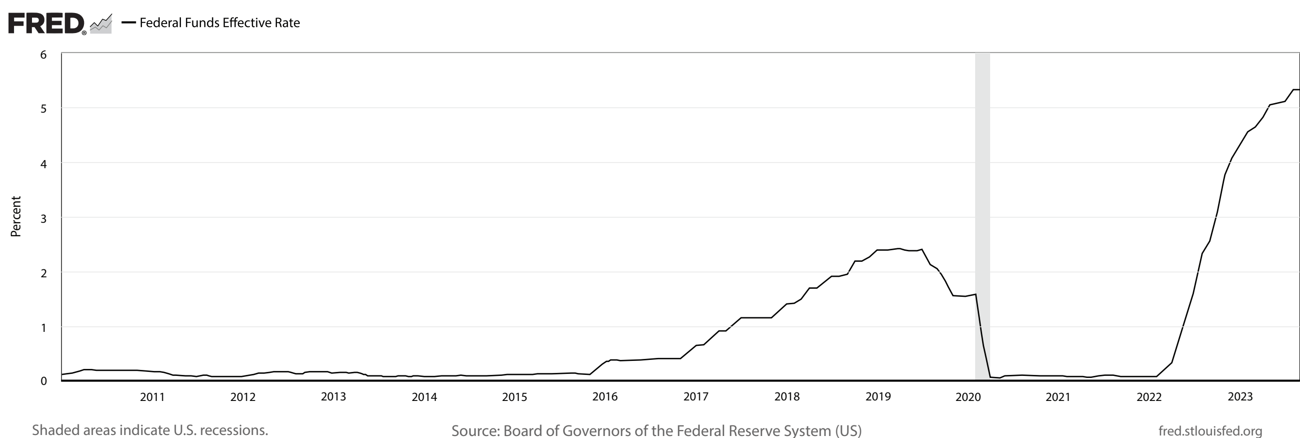
against higher rates had become extremely cheap because Fed Chairman Jay Powell made it abundantly clear that the Fed wouldn't start raising rates until the end of 2023 at the earliest (shame on me for believing him), we purchased a very cheap interest rate cap for 30 months that would make payments to the owners of approximately 64 properties ($1.7 billion of debt) that had floating-rate loans in the event 30-day LIBOR exceeded 1.25%. We felt like 30 months was a good length of time to protect ourselves, and when rates did go higher they wouldn't exceed the previous 2.50% peak by very much. Boy were we wrong.

Back to the metaphor. Our excitement and complacency were akin to us looking out the window as the weather kept slowly getting worse. As previously mentioned, I personally found myself feeling like we were safely perched in a lovely home looking out a window with a beautiful view but well protected given our interest rate cap and believing that rates would not go beyond 2.50% to 3.00%.

Unfortunately, it turned out that metaphorically the windows had leaks and let some of the blustery snow come in along with the temperature dropping such that we now found ourselves having to defend from the snow covering us and make sure we had the tools and provisions to not only periodically do some digging to provide more air and light, but to also ensure we have the resources to weather such conditions for a long period of time should this be the case. I'm being a bit dramatic, but it helps to convey the radical change in conditions that occurred within a relatively short period of time that not only affected CWS, but other apartment owners and especially developers.

This chart shows the path of the main interest rate the Federal Reserve controls, the Federal Funds Rate. We prospered handsomely for many years as rates stayed near 0% and when they did reach the previous cycle peak of approximately 2.50% our portfolio was manageable. It turned out what we were not as well prepared for was what transpired after 2022 when our portfolio hedge expired and rates were much higher than projected, and now, which may remain there for longer than we, and many others, expected.



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Permafrost is any soil or underwater sediment that remains frozen for at least two years regardless of the underlying temperature of the earth below. We believe that conditions will remain challenging through 2025 from both an interest rate perspective and operationally as many of our markets are facing a large number of new units coming online at a time when there are cost pressures in terms of property taxes, insurance, and labor. Attracting and retaining quality associates is expected to remain a challenge as the industry has a strong need for workers with so many new communities being completed and a large number still under construction. With our 54 years in business and having operated through many cycles over this long amount of time, we have been battle-tested and scarred which has afforded us wisdom to do our best to have created a strong layer of permafrost under us that will always keep us on solid ground even if we still have snow coming down on us. It also requires that we be intensely focused on optimizing the use of our precious resources, akin to food and water, to ensure we are sufficiently provisioned to get us through 2025.

It is imperative that we preserve our cash by adjusting distributions lower, or suspending them, when necessary (as we have already done), only doing capital projects we deem essential, and being very aggressive in bringing in additional capital where it is necessary to help us weather the storm. Fortunately, out of 107 properties, we are currently estimating the need to bring in additional capital for approximately 10 in the range of 5% to 10% of one's original investment. While this is not the place we wanted to be, we take some comfort in knowing that for the vast majority of these we believe that our leverage levels are such that new money invested that would be senior in the equity repayment hierarchy should have a strong margin of safety associated with it. We have been here before and our experience has taught us that being invested in a business such as apartments, even during difficult times when additional capital investments are required, has a high probability of working out because it's a business which has great long-term demand fundamentals and is not easily disrupted like so many other industries are.

Apartments have been a very forgiving asset class in terms of weathering difficult times for those with financial and emotional staying power. This is because well located apartments in growing areas will always be in demand at a price because they provide an essential need which is shelter, flexibility, and minimal capital required for consumers of the service. As such, there will always be a rent level to create a household to fill vacancies. And while supply and demand will almost always intersect, it will not always be at a level that signals to construction lenders and equity providers that providing capital to apartment developers offers rewards commensurate with the risk. As such, this should enable apartment owners who can stay on the field during the difficult times to come out the other side to take advantage of strong pricing power when there is not enough supply at a time when demand has accelerated.

The conditions that we are facing today, in which interest rates have risen rapidly and to unexpectedly high levels, have impacted asset values and dramatically lowered transaction

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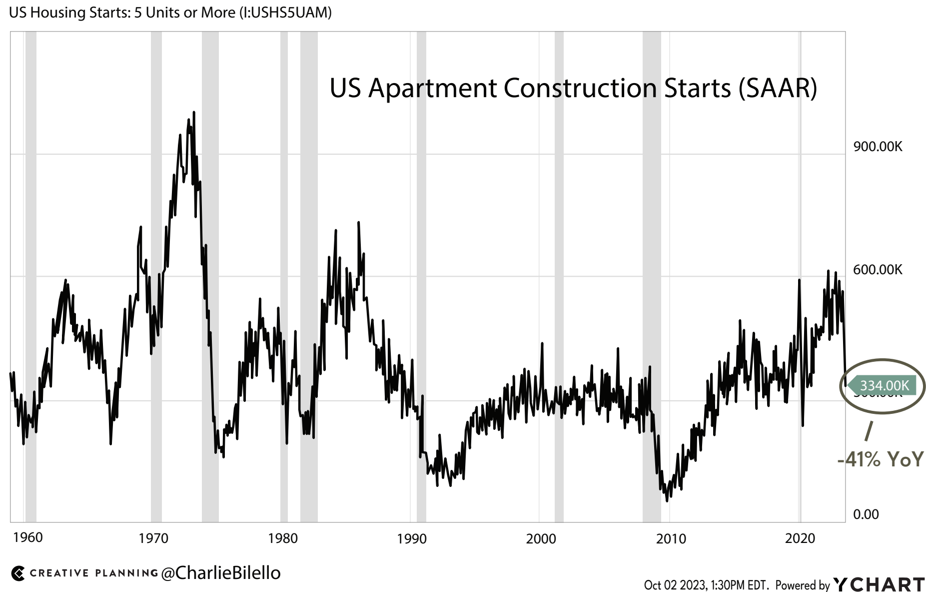
volume. Most importantly, however, for long-term investors it is also shutting down the new construction pipeline as this chart shows.



This is why we are going to fight hard to make sure we not only have the staying power to do all we can to weather the storm of higher rates impacting our cash flows, but to position ourselves to take advantage of opportunities that will inevitably rise. New apartment starts have dropped 41% over the last year, which is the steepest drop since 2010, and I don't see why this trend won't continue given where interest rates are and how difficult it is to access construction financing. As a result, the stage is being set for supply to be insufficient to meet future demand. And let's throw in this chart showing how unaffordable homeownership has become for new buyers, which should only serve to keep people renting longer than they otherwise would.

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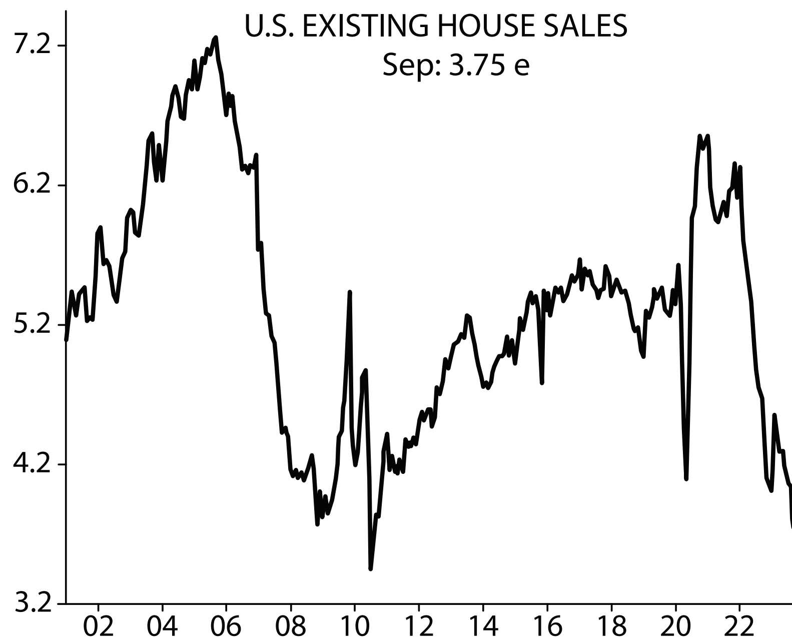
The plumbing of the housing market is clogged because so many homeowners are locked into fixed-rate loans at much lower rates than what can be accessed for new loans today. There is no incentive to refinance, and it makes no sense to move and give up one's low rate loan only to buy a home that will cost the same or more with financing that is so much higher. Home prices have not come down because there are so few homes on the market so those with cash or the ability to access financing at today's rates still exceed the number of sellers in most markets. This chart shows how existing home sales have reached levels lower than the depths of Covid.



There are two ways to unclog the housing market. The first is through dramatically lower prices to make homes much more affordable with today's much higher mortgage rates or by mortgage rates coming down by around 2% to 5.50% or less. I would not bet on the former because that would necessitate a large number of distressed sellers which I don't see happening given the significant equity most people have in their homes financed by low-cost mortgages that homeowners do not want to give up. This leads to lower rates being the lever. Lower rates also have the added benefit of making it more economical for builders to produce new supply which can help lessen the inflationary pain that housing will cause in the future if new supply is not generated to meet the demand that will be growing due to population expansion and kids moving out of their parents' homes.

Another benefit of lower rates is the support it can provide the banking system. Since homeowners have an asset with their low interest rate mortgages this means that banks and other lenders have a liability. By meeting in the middle with lower rates, this can help unclog the housing market and reduce the amount of underwater mortgages banks have and help improve what is becoming an increasingly tenuous capital position for smaller local lenders and

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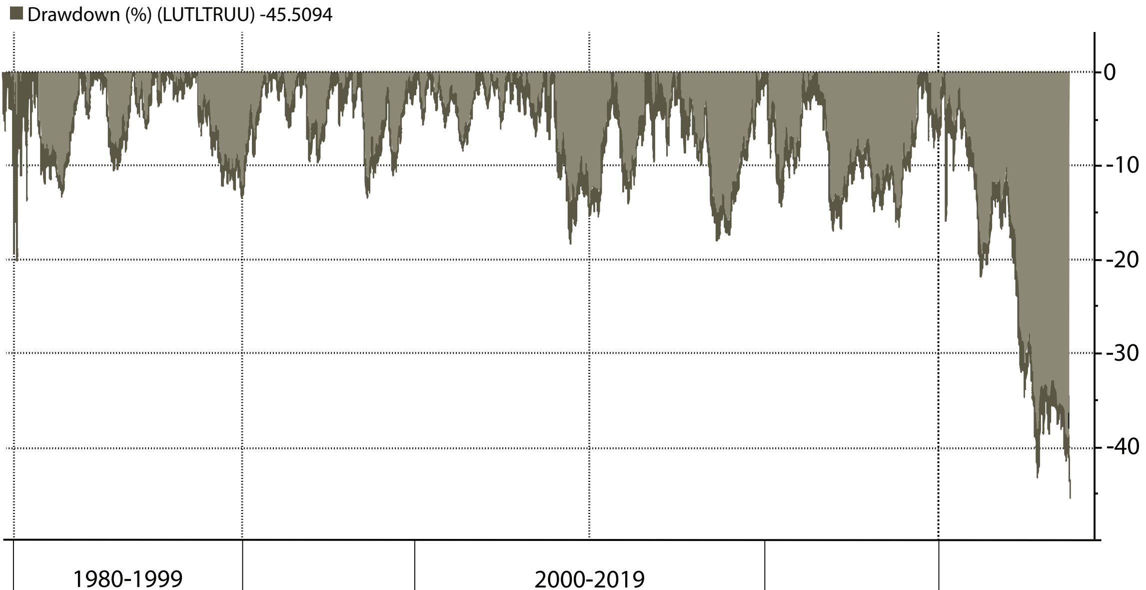
regional banks. It will also elicit more transaction volume which will help stimulate economic activity. This chart shows how owning long-dated Treasurys has created huge paper losses as these have come down in value with rates having gone so much higher. This is a good representation of what has happened to the value of low interest rate mortgages banks have on their books.



Much of the increase in rates has been a result of investors requiring much higher real rates (after inflation) versus raising their inflation expectations. This chart shows how break-even inflation rates for 5-year TIPS have come down to approximately 2%, which is right at the Fed's target.

The dramatic increase in longer rates is mostly attributable to inflation-adjusted rates shifting from very low to negative to much higher real rates that now exceed 2%. This has created risk-free alternatives that allow investors to earn much higher passive income and has forced

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a repricing of risk assets, particularly ones that utilize leverage such as real estate.

● 10 Year Treasury Rate (I:10YTCMR)

● 10 Year Real Treasury Rate (I:10YRTR)

CREATIVE PLANNING @CharlieBilello

Oct 02 2023, 10:59PM EDT. Powered by YCHARTS

And while apartments are nothing like office buildings in terms of its industry challenges, there is going to be pain for apartment owners who were very aggressive with their borrowings as they are at risk of losing their properties unless they can negotiate significant modifications with their lenders and/or raise a tremendous amount of additional capital to pay down or refinance their high-cost, high-leverage loans that are maturing or have debt service that greatly exceeds their operating income.

The fourth quarter is going to be very revealing economically because starting October 1st the moratorium on student loan payments came to an end for millions of borrowers. This will take over $100 billion out of the economy. And given how high gas prices are now, higher interest rates pushing up borrowing costs significantly, and credit sensitive industries are completely paralyzed due to so few transactions taking place, it seems hard to fathom that economic growth won't be impacted. Like many others, I have been thinking that a recession was going to take place much sooner because I put a lot of faith in the inverted yield curve which occurs when short rates are higher than long rates. It reminds me of my worries back in 2002 regarding mortgage lending and how it turned out I was way too early. I underestimated the power of so many consumers having low-cost fixed rate mortgages, as well as many corporations. And if cash balances have increased for those cohorts, then the

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much higher risk-free rates available have resulted in a net benefit for them.

What I subsequently realized, however, upon doing more research is that recessions do not take place until the yield curve becomes positive again such that long rates are higher than short rates. Another wrong prediction from my end was that I thought this would primarily occur via short rates coming down much faster than long rates as opposed to long rates going much higher (or a combination of both). We finally have our first de-inversion with the 10-year yield now exceeding the 5-year Treasury yield. I'm in good company with me being on recession watch with famed bond market investor pointing out the same thing regarding the de-inversion of the yield curve and associated recession risks.

Jeffrey Gundlach
@TruthGundlach

The US Treasury yield curve is de-inverting very rapidly. Was at -108 bp a few months ago. Now at -35 bp. Should put everyone on recession warning, not just recession watch. If the unemployment rate ticks up just a couple of tenths it will be recession alert. Buckle up.

5:02 PM · Oct 3, 2023 · **558.4K** Views

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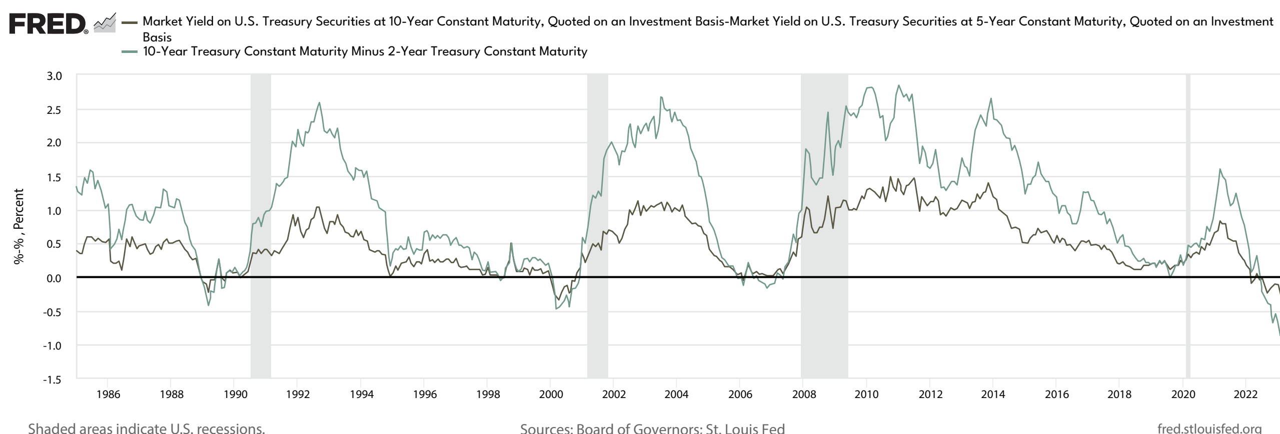
I will now be watching very closely the spread between the 10-year Treasury and 2-year Treasury. These two yields seem to be on an inevitable course to de-invert as well. This chart shows the two curves (10s and 5s and 10s and 2s) and how they have cycled over the years.



One can see when both curves turn positive (de-invert) a recession has occurred the last four recessions. What's unusual about today is that there is a much bigger gap between the two curves in that when the 10s and 5s are close to 0, the same is true for the 10s and 2s. This is not the case when the curve is very steep. When this is the case, the differential between 10s and 2s is much greater than that of 10s and 5s. During times of inversion and very flat

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curves, they have tended to be much more correlated. With the de-inversion of the 10s and 5s I would say we're now on recession watch. Once the 10s and 2s de-invert then to me it's a clear recession warning. And this will finally get us to the point where the Fed will be officially done raising short-term rates and we can finally be in a position again to get some relief with the prospect of lower rates being much more feasible.

We feel like the permafrost we're supported by, which includes property cash reserves, corporate cash, and access to additional capital from our investors in those cases that are facing the squeeze of interest costs (including the need to reserve for very expensive interest rate caps) exceeds the operating income and does not have sufficient cash reserves to handle the shortfall, along with our deep and very talented team, will get us through 2025 as well as set us up to take advantage of opportunities that we anticipate will be incredibly compelling as many others may not have as firm of a foundation as CWS.

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