Volume 28, No. 1, April 25, 2014

QUARTERLY UPDATE

CWS CAPITAL PARTNERS LLC

CWS Capital Partners LLC

CWS

CALENDAR OF EVENTS

May 2014
CWS Capital Partners
Semi-Annual Conference Call

Monday, May 26, 2014
Memorial Day
CWS Offices Closed

Friday, July 4, 2014
Independence Day
CWS Offices Closed

July 15, 2014
2nd Quarter 2014 Estimated Tax Payment Due

July 25, 2014
2nd Quarter 2014 Quarterly Packages Mailed

Monday, September 1, 2014
Labor Day
CWS Offices Closed

October 15, 2014
3rd Quarter 2014 Estimated Tax Payment Due

Friday, October 31, 2014
3rd Quarter 2014 Quarterly Packages Mailed

Thursday, November 27, 2014 and Friday, November 28, 2014
Thanksgiving Day and Day After
CWS Offices Closed

Wednesday, December 24, 2014 and Thursday, December 25, 2014
Christmas Eve and Christmas Day
CWS Offices Closed

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LOOKING BACK AND LOOKING AHEAD

By Gary Carmell

Note: Much of this is adapted from Gary's presentation at CWS' 2014 Annual Investor Meeting held on April 11, 2014

I have heard someone ask the question, "How do you avoid an avalanche?.... Don't be on the mountain when one occurs." If an investment drops by 50% then obviously it has to double to get back to break even, which is no easy feat. It's been said that markets go up like an escalator and drop like an elevator. Long-term investment success requires avoiding devastating losses and doing all one can to stay off the mountain when the avalanche occurs. It does require being on the mountain for much of the time, however, as there is no reward without exposing oneself to some risk.

Although we have had our share of challenging situations at CWS over our 45 years, we have generally avoided catastrophic mistakes. This wasn't because we were not

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exposed to investments that didn't drop in value during the holding period. Rather, it was because we had the staying power and tenacity to work through problems when they arose and brought in capital and/or restructured loans to give us the breathing room to do what was necessary to hang in there until markets recovered or we could refinance with much lower cost debt.

As our long-term investors know, CWS was one of the largest owner/operators of manufactured home communities in the 1980s prior to diversifying into apartments. We started selling manufactured housing communities and exchanging the money into apartments in 1990 on a tax-deferred basis. We slowly whittled away at our manufactured housing portfolio and grew our apartment business until we exited the manufactured housing business almost completely between 1998 and 2000. We sold nearly our entire portfolio and our manufactured home community management company and exchanged the proceeds into apartment communities. This catapulted the growth of that business over that two-year period. At first the trade didn't appear to be so wise as manufactured home communities continued to perform reasonably well while many of our apartment communities were challenged due to the meltdown in the NASDAQ and the corresponding tech layoffs. Furthermore, those with jobs were easily able to purchase homes as interest rates came down dramatically and underwriting standards began to loosen. This led to a drain of high-quality residents from apartments into home ownership, leaving apartment owners struggling to maintain occupancy and needing to offer incentives to retain and attract residents.

Compounding the problem was our decision to finance our investments with long-term (typically 7 to 10 years), fixed-rate loans. A couple of these loans had rates in the 8% range and became very problematic when our revenues dropped and interest rates also fell as the economy weakened in the face of the tech wreck and 9/11. We could not refinance due to cost prohibitive prepayment penalties. For some properties this necessitated bringing in additional capital to support the investment due to negative cash flow until either operations improved or, more importantly, we could refinance into lower interest rate loans. The Marquis at Town Centre in Broomfield, Colorado illustrates this point well. We bought Town Centre in 2000 and put a 10-year, 8% fixed rate loan on it to help finance the purchase. Denver was decimated by the tech downturn as it had tremendous exposure to telecom jobs which were eviscerated after the tech bubble burst and venture capital and IPO money dried up. During the darkest of times it is often hard to see a much brighter future ahead. Most of us have a tendency to extrapolate current conditions into the future

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versus being able to envision something very different. We were faced with the need to raise additional capital to support the investment. We knew in the long run we would be OK because we had a great property in a terrific location in a city with a favorable long-term future. We were also confident that even though it was going to take another seven years to get out of the debt, interest rates would be a lot less than 8%. The following table shows the precarious situation in which we found ourselves in 2003.

	Projected in 2003
Revenue	2,873,000
Expenses	(1,293,000)
Net Operating Income	1,580,000
Capital Expenditures	(127,000)
Cash Flow before Debt Service	1,453,000
Debt Service	(2,159,000)
Cash Flow	(706,000)

Let's fast forward 10 years and see what has happened since then to see if our optimism in 2003 was warranted. Here is how the property performed in 2013:

	2013	Change from 2003
Revenue	4,283,000	49.1%

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Expenses	(1,515,000)	17.2%
Net Operating Income	2,768,000	75.2%
Capital Expenditures	(399,000)	
Cash Flow before Debt Service	2,369,000	63.0%
Debt Service	(1,802,000)	
Cash Flow	561,000	$1,267,000

It was a remarkable turnaround. The combination of revenue growth dramatically exceeding the growth in expenses along with lower interest rates led to cash flow improving by nearly $1.3 million such that the property is now cash flow positive. We have been able to make significant investments in the property to keep it first rate. We were able to return all of the additional capital invested during the downturn, and the original investors are now getting regular distributions. We are also amortizing the loan so that each year we are paying down an amount equal to nearly 4% of one's original investment.

What happened to the manufactured housing business? It was the pre-cursor to the sub-prime debacle. Starting in the mid-1990s and ending in 1999, the industry, fueled by Wall Street money seeking to securitize manufactured home loans, went on a lending spree that was a complete and utter disaster. It created artificial demand by peddling poorly underwritten and often fraudulent loans to wholly unqualified borrowers on terms that were far too aggressive for the risk being borne. The result was a tsunami of bad debt and write-offs and a rush to the exits by investors wanting nothing to do with manufactured housing paper. The following graph tells it all. It shows annual shipments of new manufactured homes in the United States since 1959. This is a good proxy for manufactured housing demand.

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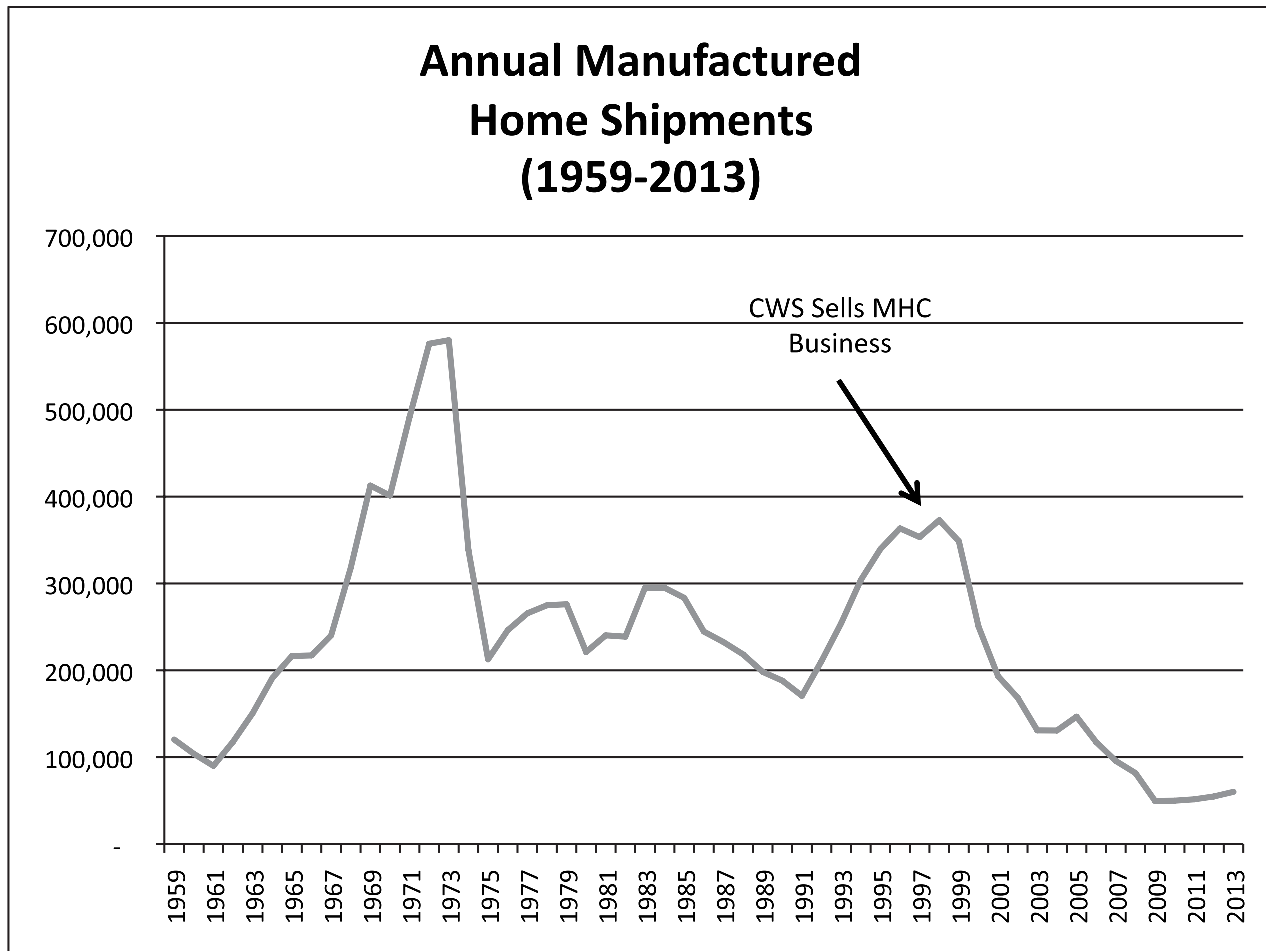

Source: Manufactured Housing Institute

With the exception of an unprecedented explosion in demand during the late 1960s and early 1970s, 1998 generated the largest shipments at nearly 373,000, which happened to coincide with the year we entered into our agreement to sell our manufactured housing business and portfolio. In hindsight our timing couldn't have been more perfect as shipments are now only in the 60,000 range, 15 years after the 1998 peak, with no prospects of any dramatic improvement.

While single-family housing is far more important to our economy than manufactured housing, this doesn't mean it won't take a long time for it to regain its glory days. Look at the following chart of new single-family sales. The run up and crash don't look too dissimilar. Although the single-family market is recovering, its growth is now occurring from a very low level of activity.

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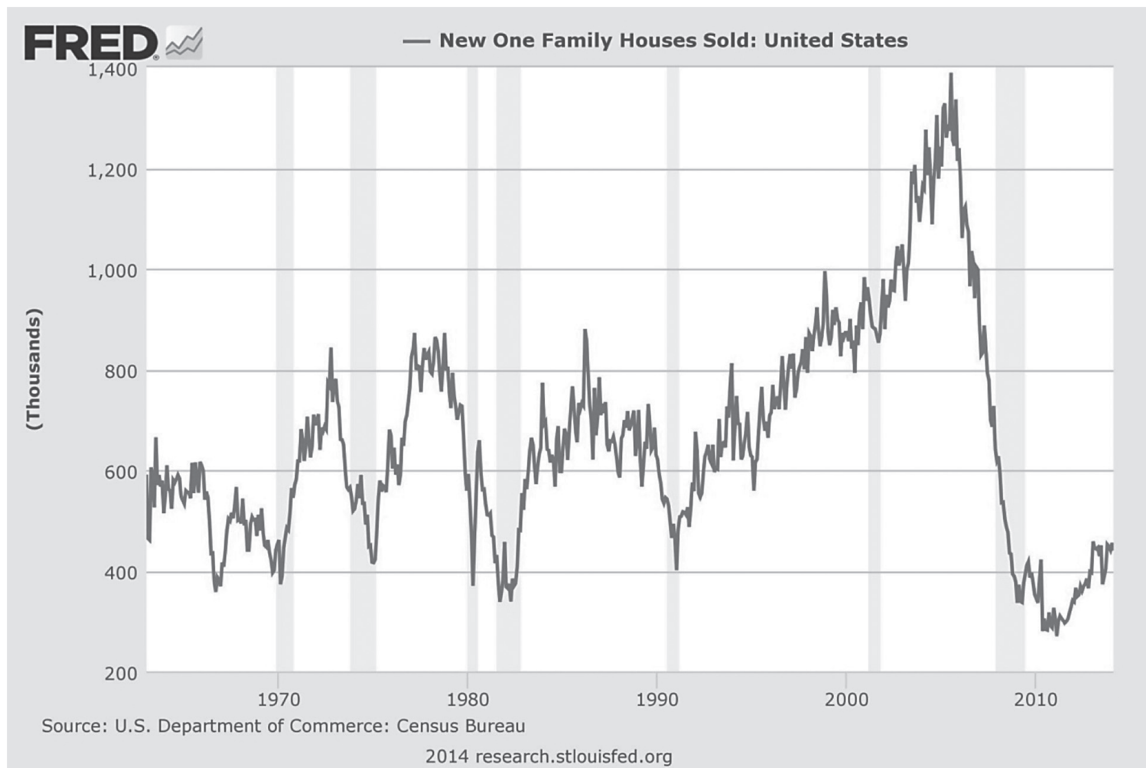

Yes, we had our bumps in the road, but we are delighted to have made the strategic move we did, shifting from manufactured housing to apartments.

So what have you done for me lately?

As we navigated our way through the Great Recession, we concluded that this would be a once in a lifetime opportunity for apartment owners and developers who could access the capital, ferret out the opportunities, and have the courage to pull the trigger to buy and build aggressively. The construction lending pool was drying up, therefore new supply wasn't a concern, so it came down to demand and interest rates. We were convinced that single-family housing would not get us out of the recession since it is what nearly brought the world economy to its knees. Renting would be in much greater demand as people had to build and rebuild their credit in the wake of the carnage of the Great Recession. They would also value the flexibility to go to where the jobs were. But when would the jobs materialize? We had to go back and study the Great Depression and government's response to it to see what lessons could be learned since the downturns had similar causes and consequences. I have written about this in the past (and more to come when I complete my book) so I won't go into the details of how we came to the conclusions we did. Suffice it to say we believed not

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only that the government would need to pull out a bazooka of stimulus, but that there was no need to worry about budget deficits causing inflation and that jobs would materialize at some point given all of the fiscal and monetary stimulus. We also didn't need a large number of jobs to have the demand for apartments far outweigh the supply since construction was coming to a screeching halt and apartment occupancies were still rather healthy despite the economic factors. Finally, apartment household formations were going to be at historically high levels due to the collapse in the single-family market and construction of new homes.

So how did we do? Were our hypotheses accurate? I would say yes, if the following results are any indication. Since 2010 we had 48 properties in our portfolio that we still owned through 2013. Here is a table showing what we produced in 2013 versus 2010 and the percentage change in major categories:

	2010	2013	% Change
Revenue	$141,451,000	$170,392,000	20.5%
Expenses	(65,396,000)	(73,289,000)	12.1%
Net Operating Income	76,055,000	97,103,000	27.7%
Capital Expenditures	(8,874,000)	(17,433,000)	
Adjusted NOI	67,181,000	79,670,000	18.6%
Principal	(4,687,000)	(8,061,000)	
Interest	(51,060,000)	(41,950,000)	
Cash Flow	11,433,000	29,659,000	159.4%
Debt Balance	907,446,000	964,542,000	
Approx. Avg. Int. Rate	5.62%	4.35%	

The power of healthy NOI growth and a minimal change in debt service allowed us to increase cash flow dramatically during these three years, resulting in much healthier distributions to our investors, strong gains in equity value, and the ability for us to re-invest significant sums into our properties with more in store for the next few years.

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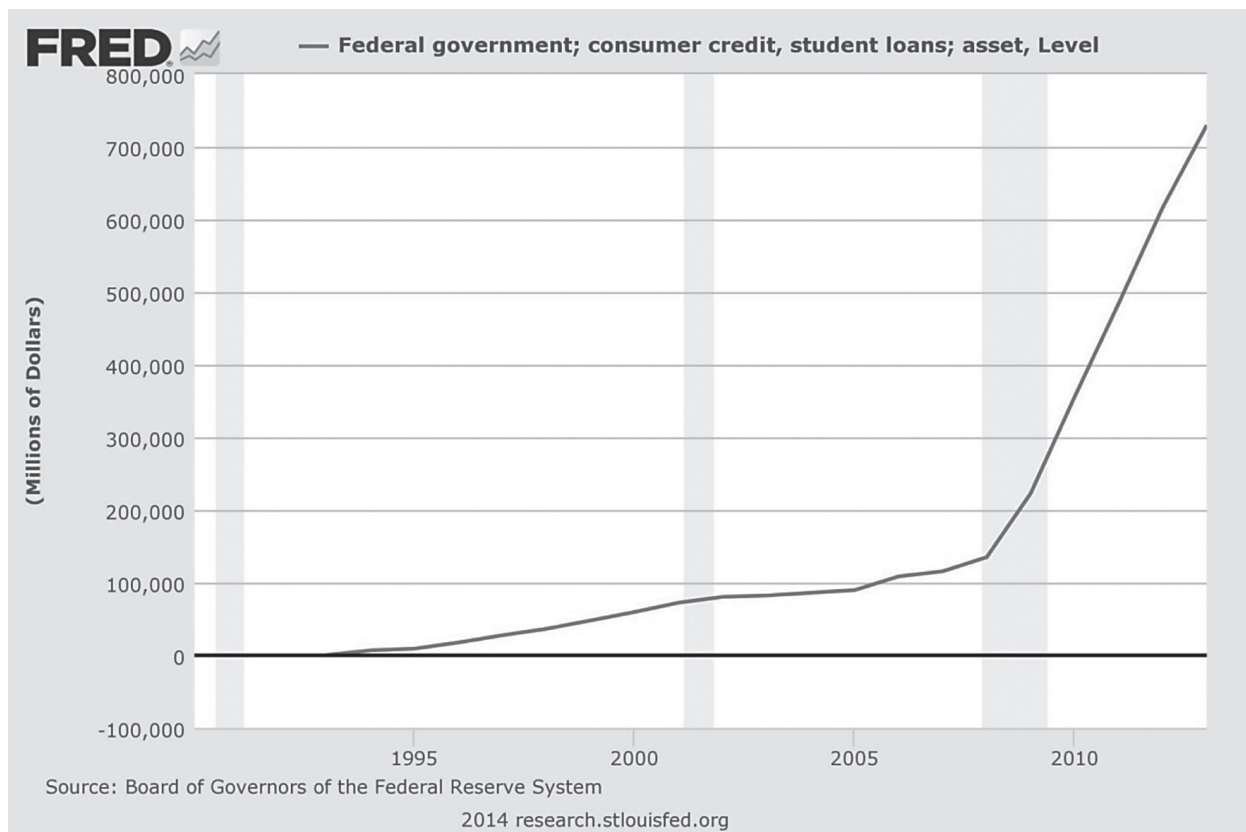
So where do we go from here?

We are still optimistic that better days are ahead for apartment owners. One of the principal reasons is the following chart:



Our prime demographic, 18 to 29 year-olds, has taken on a lot of student loan debt since 2008 when the federal government took on much of this burden. Cumulative student loans have more than doubled since 2006 to nearly $1.2 trillion. (http://econbrowser.com/archives/2014/03/addressing-growing-student-debt) These are not discharged in bankruptcies so it makes mortgage lenders more skittish to extend credit to those with a lot of student loan debt relative to their income because of this risk. In addition, credit standards are just much tighter in general, thereby making it hard for younger people without the financial resources and credit history to have access to mortgage credit. Add to this that people are getting married later (influenced somewhat by the fact that there are far more female college graduates than male), a preference among young people for higher cost

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urban areas, relatively low average job tenure necessitating flexibility, and a lingering feeling of insecurity in terms of uninterrupted earning potential, and these form the ingredients of a powerful recipe that speaks to apartment rentals continuing to be in strong demand provided job growth remains steady.

We do believe that there is an increasingly favorable risk-reward relationship in terms of building new apartment communities. We don't believe there is enough housing being built in general. Apartments should be able to fill the gap for the next three to five years lessening concerns about overbuilding. Because lenders are being quite disciplined in their requirements for large down payments and credit support, the yields that can be generated by development relative to purchasing existing properties in certain locations can be quite compelling. One of the objections people have to a development investment opportunity is that these development projects don't produce cash flow in the first two to three years. Our response is that one should be well compensated for this by the higher recurring cash flow that should materialize after the property is built and leased up in addition to the strong appreciation potential from capturing the development profit. Note the yield sacrificed is close to 0% if the alternative is having the money in the bank, so the opportunity cost of not earning a current return in the first couple of years is not nearly as material as it is in a higher interest rate environment. We are strong advocates of looking through to the potential of earning a very strong and durable income stream generated by a brand new asset offering the most up-to-date floor plans, design, and amenities in outstanding locations. For these reasons we have made an effort to have most of our CWS Strategic Apartment Funds have some development exposure.

That was a fairly quick journey over nearly 16 years, but one that was fun to recount and one we're proud to have taken since we believe we have added a lot of value to our investors' holdings with us over the years. We feel a great sense of responsibility and honor to have earned the trust of well over 700 people and to have over $900 million in capital invested with us. We don't take that responsibility lightly. Everyday we come to work trying to figure out how we can stay off the mountain when an avalanche occurs while continuing to enhance lives, the CWS way.