Volume 30, No. 1, April 29, 2016

Quarterly Update
CWS Capital Partners LLC

CWS Capital Partners LLC

CWS

Calendar of Events

May 26, 2016
CWS Capital Partners
Semi-Annual Conference Call

May 30, 2016
Memorial Day
CWS Offices Closed

June 15, 2016
2nd Quarter 2016
Est. Tax Payments Due

July 4, 2016
Independence Day
CWS Offices Closed

July 29, 2016
2nd Quarter 2016
Quarterly Packages Mailed

September 5, 2016
Labor Day
CWS Offices Closed

September 15, 2016
3rd Quarter 2016
Est. Tax Payments Due

October 15, 2016
2015 Tax Return Extensions Due

October 28, 2016
3rd Quarter 2016
Quarterly Packages Mailed

www.cwscapital.com

Better Than We Thought

By Gary Carmell

(Note: This article was adapted from the presentation I gave at our Annual Investor Meeting that took place on April 19, 2016)

Over the years I have found that it is good discipline to take the time to articulate in writing the hypotheses that are the basis of making an investment. Hindsight is of course always 20/20. The true test is how effective is one's decision making process in real time with imperfect information and an unknowable future. CWS capitalized its first Strategic Apartment Fund in 2010 with the first investment being made on December 30th of that year. Since that time we have completed seven funds, raised over $116 million, and are close to completing our 8th fund with commitments north of $25 million. With five years having gone by, I thought it would be interesting to review our thinking back in 2010, the actions we took, and the results over the past five years.

In the aftermath of the Great Recession, the mortgage market was decimated and millions of homes in foreclosure were left in its wake. Of course both fed off of each other. Easy lending led to an explosion in housing demand and increasing values, which led to more capital being available

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to prospective homeowners and higher prices. Once the tide started going out, however, everything went into reverse. Mortgages began to go bad, credit tightened, demand was significantly reduced as fewer people could access financing to buy or refinance homes, values collapsed, housing-related jobs, particularly in construction, were eliminated by the millions, and the global economy almost went into a depression. Our belief was that it would take many years for home ownership to recover. Here were the major reasons we thought there would be tremendous headwinds for home ownership and that it would be eliminated as a serious competitor to apartments for many years:

- Mortgage standards were going to tighten dramatically
- Too many people had bruised credit to qualify for loans
- Young home buyers would be shut out of the market after representing a historically high percentage of home purchases
- Increasing down payment requirements would keep people from purchasing homes
- Too many people had been decimated financially by home ownership and their psyches were scarred and this would be transmitted to other family members
- Inflexibility and high transaction costs constrain people from going to where the scarce supply of jobs were

With home ownership effectively being removed as competition for apartments, we then had to focus on the supply of new apartments and whether there would be sufficient demand to absorb the new supply. We were quite optimistic that apartment supply would come to a screeching halt for the following reasons:

- Banks were under severe financial pressure and needed to be bailed out, so they were not going to make construction loans with such a shaky economic outlook and financial situation
- Pessimism was rampant among equity providers, so very little capital was available to provide the equity for developers
- Too many developers were playing defense having to work out their construction loans that were maturing and laying off staff
- Jobs were just starting to recover but not enough to spur on investor "animal spirits" to fund new construction

The last piece of the puzzle was interest rates. Many investors feared that rates would rise because of the huge increase in the federal deficit and the need for $1 trillion+ in borrowings by the U.S. Treasury to fund the deficit. This fear, combined with overall concerns about how long it would take for the economy to start producing a meaningful number of jobs and new households, resulted in many investors demanding relatively high yields in order to deploy capital in the apartment industry. These yield requirements were significantly greater than the cost of borrowing from apartment lenders.

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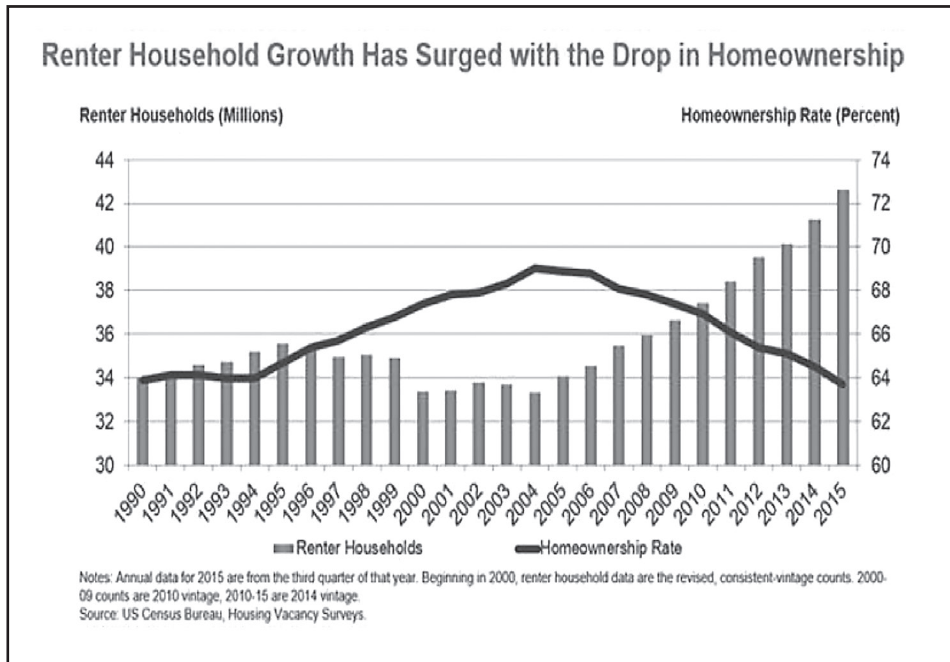
CWS had the opposite belief about interest rates and what return was appropriate for the risk being borne by apartment buyers. We thought that federal deficits were just what the economy needed to get it out of the abyss; interest rates would not only not rise, but they would remain low for many years to come. The combination of no competition from home buying, the collapse in new single-family and apartment construction, a slowly improving economy, low interest rates for the foreseeable future, and loans being available from Fannie Mae and Freddie Mac, created an extraordinary opportunity to load the boat with apartment investments and eventually embark on building new communities as well. We believed that revenues would grow meaningfully faster than expenses, resulting in rapid growth in Net Operating Income (NOI). This growth in NOI, when combined with what we believed would inevitably be falling capitalization rates as investors come to recognize the growth prospects of apartments with their relative safety, would result in a tremendous increase in values.

Our thesis proved correct as home ownership dropped quite precipitously while rental demand has exploded as the following chart shows.



Did the macro trends filter through to CWS operating results? I would say unequivocally yes as the results produced by the properties that have been in our portfolio since 2010 show.

	2010	2015	% Change
Revenues	$127,712,387	$166,694,652	30.5%
Expenses	58,224,922	70,622,713	21.3%
Net Operating Income	$69,487,465	$96,071,939	38.3%

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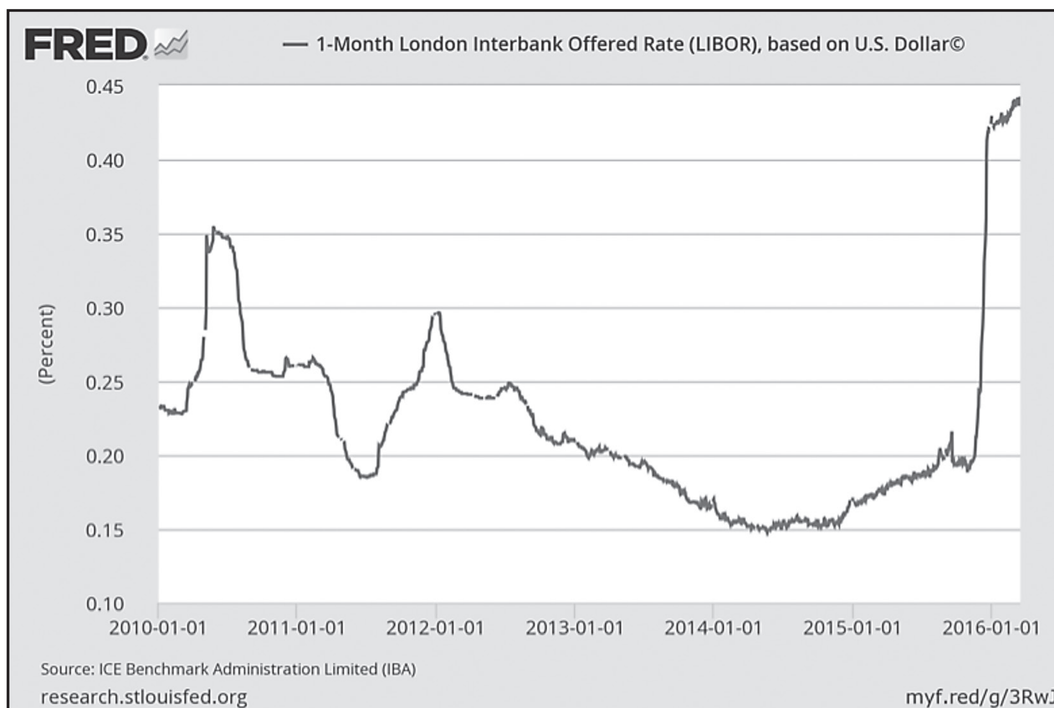
Since real estate is an asset class that can be leveraged by using borrowed money to finance the purchase of properties, borrowers can prosper handsomely when they experience a meaningful growth in NOI. This is what has happened in the CWS same-store portfolio during the last five years. For example, the 38% growth in NOI can translate into over 100% growth in one's equity if the equity in the portfolio was less than 38% in 2010, exclusive of any participation in the profits by the General Partner. This does not include the additional return generated by dividends and refinance distributions that may have taken place, which turned out to be quite substantial as I will show shortly. But before getting to this, however, I have to review what happened to interest rates since this was a big part of our strategy and contributed to the dividends we were able to pass out to our investors.

So what did happen to interest rates? Our strategy was to become aggressive variable-rate borrowers since we believed that rates would stay low for a long time, these loans were cheaper than fixed-rate alternatives, and they offered far better pre-payment flexibility. In addition, beginning in 2011, Fannie Mae began offering 10-year, variable-rate loans that turned out to be a game changer as it offered us a very long loan term, which was previously not available from other lenders for variable-rate loans. This became our loan of choice with the crescendo being an 18-property refinance we did with Fannie Mae in March and April 2015 at loan terms that were incredibly favorable and could not be duplicated today.

Our intuition about rates staying low has been proven out. All of our variable loans are based on 30-day Libor. Here is a chart of what Libor has done since 2011.



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Despite the recent increase after the Fed hiked rates in December 2015, 30-day Libor has averaged approximately 0.22% during this time and by my calculations CWS has saved over $46 million in interest during this time versus the fixed-rate alternatives. This does not include the millions of dollars we saved in pre-payment penalties for loans we paid off early either through selling properties or refinancing them. Fixed-rate loans have incredibly onerous pre-payment penalties that would have precluded us from selling properties, or at least getting as high a value, because buyers would have to assume those loans. In addition, these pre-payment penalties would have prevented us from being able to take advantage of lower rates or better loan structures through refinancing the underlying fixed-rate loans. Variable-rate loans, on the other hand, have a much lower cost pre-payment structure thereby allowing us to maintain great flexibility to sell or refinance properties with minimal economic cost related to pre-paying those loans.

What did we do to take advantage of the opportunity since 2011?

- We purchased 50 properties with an aggregate purchase price in excess of $2.0 billion
- We sold opportunistically – 22 properties
- We refinanced opportunistically – 36 properties
    - Lowered debt service
    - Returned capital
    - Maintained pre-payment flexibility
- Deferred taxes by carrying out 1031 exchanges
- Added value through development
- Created "loaded guns" through the creation of CWS Strategic Apartment Funds

The combination of significant growth in our portfolio, strong growth in operating income, low interest rates, and a more competitive loan market and demand for apartments led to a dramatic growth in distributions from operations, refinances, sales, and the completion of tax-deferred 1031 exchanges. The following table shows the dramatic improvement in distributions between 2010 and 2015.

	2010	2015
Investment Base	$366,098,318	$740,396,666
Quarterly Distributions	7,817,278	59,948,400
Refinance Distributions	$1,000,000	$95,689,189
Sale Proceeds	0	53,137,617
Total Distributions	$8,817,278	$208,775,206
1031 Exchange	0	76,309,615
Total with Exchanges	$8,817,278	$285,084,821

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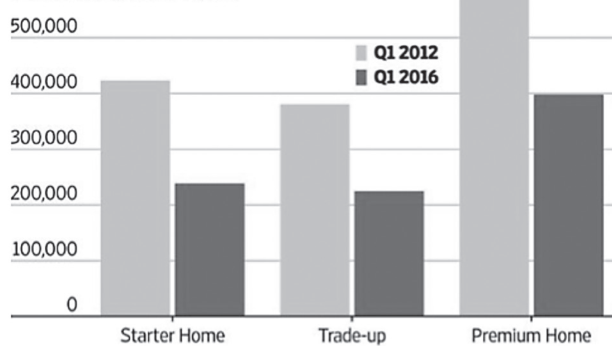
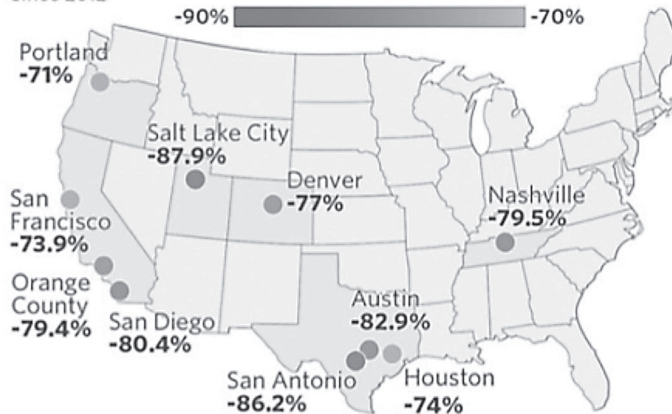
The natural question is what inning are we in? We appreciate what you have done with our investments so far but is it still a good time to deploy more capital into apartments? I think the answer is still yes. While apartment supply is increasing we still do not believe there is enough housing being built to satisfy the demand. Of course this may vary in different cities but we think this is true on a national basis.

Most importantly, we still do not believe that home ownership will siphon off a lot of demand from our renter pool because of the dearth of starter home inventory. The following charts show what has happened over the last few years to the inventory of starter and trade-up homes.



A number of the markets we are invested in are most acutely affected as the following graphic depicts.



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Finally, this table from Ellie Mae shows how underwriting standards remain tight for conventional purchase mortgages as well as refinances. We care more about the former since purchases can move people away from renting to home ownership. FICO scores have averaged over 750 for the last year with loan-to-values in the 80% range. Thus, people need substantial down payments and strong credit to qualify for conventional mortgages.

PROFILES OF CLOSED CONVENTIONAL LOANS

Closed Loans

	2016	2015													2014		
	Feb	Jan	Dec	Nov	Oct	Sep	Aug	July	June	May	Apr	Mar	Feb	Jan	Dec	Nov	Oct
CON-REFI																	
FICO	726	726	727	727	726	728	727	727	732	738	738	742	747	741	737	739	734
LTV	69	69	69	69	69	69	70	70	70	70	70	70	70	70	70	70	701
DTI	25/40	25/40	25/39	25/40	25/40	25/40	25/40	25/40	25/39	24/38	24/38	24/37	24/36	24/37	24/38	24/38	25/39
CON-PUR																	
FICO	752	753	754	754	754	755	756	757	757	757	756	755	754	752	753	754	754
LTV	81	80	80	80	80	80	80	80	80	81	81	81	81	80	80	80	80
DTI	23/35	23/35	23/35	23/35	22/34	23/34	23/34	23/34	22/34	22/34	22/34	22/34	22/34	23/35	23/34	23/34	23/34

CON-REFI (% OF REFIS @ 95 LTV+)

	2016	2015													2014		
	Feb	Jan	Dec	Nov	Oct	Sep	Aug	July	June	May	Apr	Mar	Feb	Jan	Dec	Nov	Oct
%	5.2%	5.7	5.3	5.1	5.7	5.8	5.9	5.8	5.4	4.9	5.2	4.3	4.9	6.0	6.2	5.5	6.4

Source: www.elliemae.com

For those of you who have been on this prosperous journey with CWS for the last five years we truly appreciate your support. And for those of you who have not, we still think there is daylight ahead and that apartments should still offer a compelling risk-reward relationship in a very low yielding, slower growth environment that we think will be present for many years to come.

Gary Carmell's Website – Videos Now Available to View

Gary's website and blog have been extremely successful in communicating his daily thoughts and insights regarding investing, wealth creation, real estate, interest rates, philosophy, music, and life in general. He has distinguished himself from most financial advisors by not only helping individuals grow their wealth, but by also helping investors become wealthy in life.

Just recently, Gary has added video segments to his website that range from past CWS Annual Investor Meetings, to thoughts from his book *The Philosophical Investor: Transforming Wisdom into Wealth*, to life lessons that he has learned from his many years as a husband, a father, an investor, as well as a partner in a very successful investment management firm for almost 30 years. Gary's videos are available to view on his website at **www.garycarmell.com/videos**.