Volume 31, No. 1, April 28, 2017

Quarterly Update
CWS Capital Partners LLC

CWS Capital Partners LLC

CWS

CALENDAR OF EVENTS

May 2017
CWS Capital Partners
Semi-Annual Conference Call

May 29, 2017
Memorial Day
CWS Offices Closed

June 15, 2017
2nd Quarter 2017
Est. Tax Payments Due

July 4, 2017
Independence Day
CWS Offices Closed

July 28, 2017
2nd Quarter 2017
Quarterly Packages Mailed

September 4, 2017
Labor Day
CWS Offices Closed

September 15, 2017
3rd Quarter 2017
Est. Tax Payments Due

October 16, 2017
2016 Tax Return Extensions Due

October 27, 2017
3rd Quarter 2017
Quarterly Packages Mailed

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The Next 30+ Years

By Gary Carmell

(Note: This is a partial adaptation of the presentation Gary made at CWS' 2017 annual investor meeting held on April 18th.)

This is my 30th year at CWS so I thought this would be an appropriate time to look back on some important trends during my three decades at CWS and to then look ahead to see if apartments are well-positioned going forward.

When I started at CWS in 1987 we had a portfolio worth approximately $250 million invested entirely in manufactured housing communities and today we only own one manufactured housing community and have over 24,000 apartment units worth approximately $4 billion.

As apartment investors we want to have a tailwind of growing demand. This starts with population growth. There is a chart at the top of page 2 showing U.S. population growth since 1987:

The U.S. population has grown by nearly 81 million during this time which has led to the formation of 36 million new households. So what has happened in the world and economy during this time? Quite a bit actually as the table I put together shows - see page 3.

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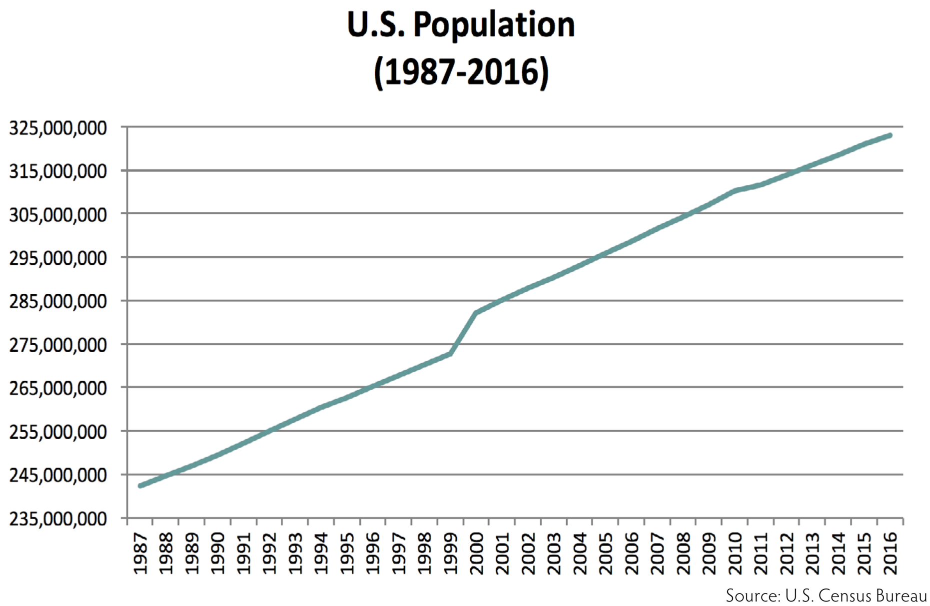

The following companies did not exist when I started with CWS:

- Amazon (1994, $429 billion market cap)
- Netflix (1997, $62 billion)
- Google (1998, $576 billion)
- Salesforce (1999, $59 billion)
- Tesla (2003, $49 billion)
- Facebook (2004, $408 billion)

That is nearly $1.6 trillion in market value that has essentially been created in the last 20 years or so. And if we add Apple to the mix which was on the brink of bankruptcy in 1997 to now become the most valuable company in the world, then the cumulative market capitalization exceeds $2.3 trillion.

Despite all of this turbulence and disruption through technological innovation, the American economy has kept growing and new households forming. Why did this occur and is this something we should continue to believe will happen despite the seemingly perilous times we're living in? The principal reason is that our free market system creates great incentives to satisfy the ever changing needs of consumers and businesses around the world. And what starts off as producer surplus, or excess rewards going to firms, then shifts to consumer surplus as high profit margins and growing industries attract new competitors which lowers prices and increases quality. This tends to raise living standards, increase economic output, and make American businesses more valuable over time. This creative destruction, however, is pretty messy which makes it hard to pick winners. There are so few companies that actually survive beyond 10 years, let alone turn into an Amazon or Apple.

The following chart does a good job of showing this creative destruction in action. It shows how relatively few stocks earn a positive return over a decade holding period. This doesn't mean one can't earn satisfactory returns by being sufficiently diversified, but it does show how difficult it is to succeed in the long-term for American businesses and

Continued on Page 3

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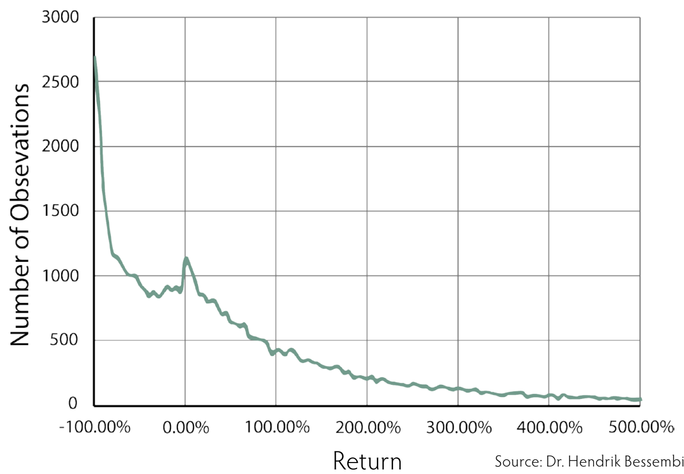
Wars/International	Natural Disasters	Economic Issues	Social Issues
Berlin Wall falls and collapse of Soviet Union	Hurricanes – Hugo, Andrew, and Katrina	Stock market crash	Rodney King and L.A. Riots
Kosovo and Bosnia	Northridge earthquake	S&L collapse and RTC creation	O.J. Simpson trial
1st Gulf War after invasion of Kuwait by Iraq	Earthquake and tsunami that killed 280,000 people	Drexel Burnham and Junk bond collapse	Growing economic inequality
Rwanda genocide	California drought	Tequila crisis in Mexico	Education gap
September 11	Haiti earthquake that killed 160,000	Long-term capital blow up	Nationalism
Afghanistan	Cyclone in Bangladesh that killed 138,000	Asian currency crisis	Huge political divide
2nd Gulf War	Kashmir earthquake that killed 100,000	Dotcom bubble and crash	Social media and balkanization of America
Israel & Hezbollah	Earthquake in China that killed 80,000	Housing bubble and crash	
Arab Spring		Lehman Brothers, AIG, Fannie Mae, Freddie Mac, forced sales of Merrill Lynch and Bear Stearns, TARP	
Syrian Civil War		Automation, Artificial Intelligence, robots, digitization, globalization, outsourcing	
Russian takeover of Georgia and Crimea		Emergence of China	
North Korea provocations		Oil volatility	
China disregarding international law in the South China Sea		Start ups	
Shia-Sunni war with Iran sponsoring Shias and Saudis behind Sunnis			
Yemen Civil War			

Continued on Page 4

Continued from Page 3

those that do are able to grow and gain dominance at the expense of those who couldn't last. The average life of a company in the database is approximately seven years and only 42% of common stocks produced lifetime returns that exceeded the returns produced by one-month Treasury Bills over the same horizon. Remember this chart as I discuss the benefits of apartments over the long run.

Figure 1B: Decade Holding Period Returns (rounded to 5%)



Source: Dr. Hendrik Bessembinder of Arizona State University

The second reason we should often look through the noise of most events is because of psychology and the ability of markets to often see through them. Markets tend to climb the proverbial wall of worry because, as Sir John Templeton has famously said:

> *"Bull markets are born on pessimism, grown on skepticism, mature on optimism, and die on euphoria. The time of maximum pessimism is the best time to buy, and the time of maximum optimism is the best time to sell."*

There will always be uncertainty and worries and cyclical deviations from trend but the natural progression of the United States is to grow.

Now that we have established that the U.S. population should continue to grow despite there always being bad things to contend with in terms of international risks, social changes, economic disruption, and economic excesses that unwind in painful fashions, the question is: Are we invested in a business with good long-term fundamentals? I would assert that apartments do have them. Let's first look at some macro numbers and then dive into why these trends should still hold.

	1987	2016	Change/Avg.
Population	242,288,918	323,127,513	80,838,595
Households	89,480,000	125,820,000	36,340,000
People/Household	2.71	2.57	2.22

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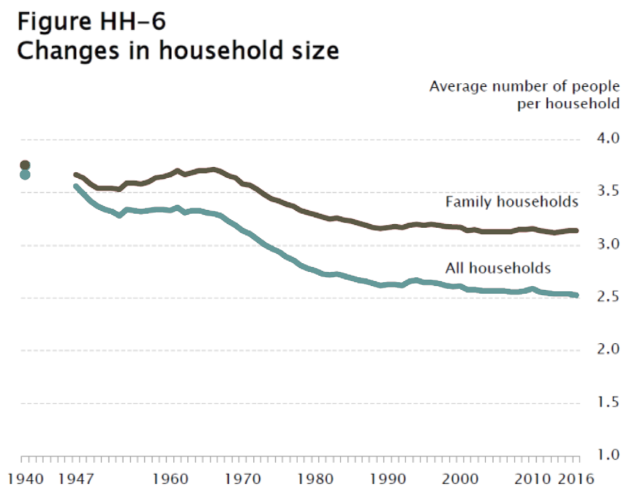
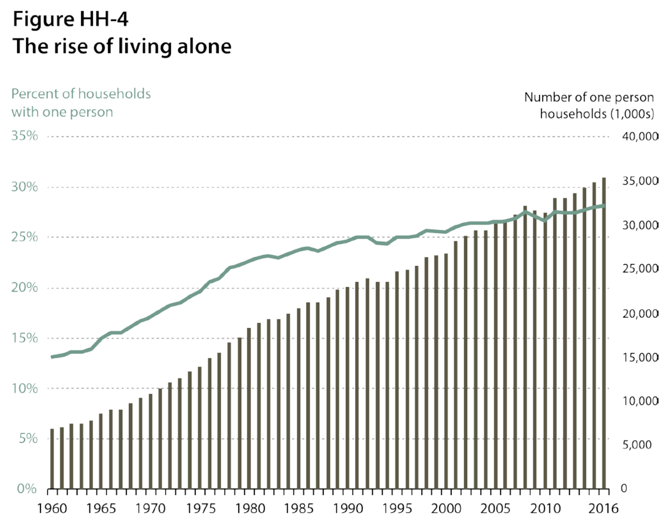
The following charts show how the average home size has been dropping over time and this is primarily due to the second chart which shows a substantial increase in the percentage of households populated by people living alone.





Household formations have grown by approximately 36 million during this time, or by 1.25 million per year. What is equally important is that the average household size has been dropping. In 1987 the average household was occupied by 2.71 people. This has dropped to 2.57 as of 2016. To bring about this drop meant that the average size of new households formed between 1987 and 2016 was 2.22. This is important because if this trend holds then this would mean more households being formed than if one just uses the current average household size. It's important to analyze what is happening at the margin.

So why should apartments have solid long-term demand fundamentals? Let me first show what it's not very easily susceptible to. It should not be faced with existential risks like this headline alludes to for a monstrous company like Cisco.

AT&T just completed a first-of-its-kind test — and Cisco should be terrified

Julie Bort
16h 28,253

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Source: Source: http://www.businessinsider.com/att-white-box-test-should-scare-cisco-juniper-2017-4

Secondly, purchasing well-located apartments and having the financial staying power has always resulted in a positive return for CWS investors. The average internal rate of return in the 69 apartments we have sold since 1996 has been in excess of 14% per year.

Continued on Page 6

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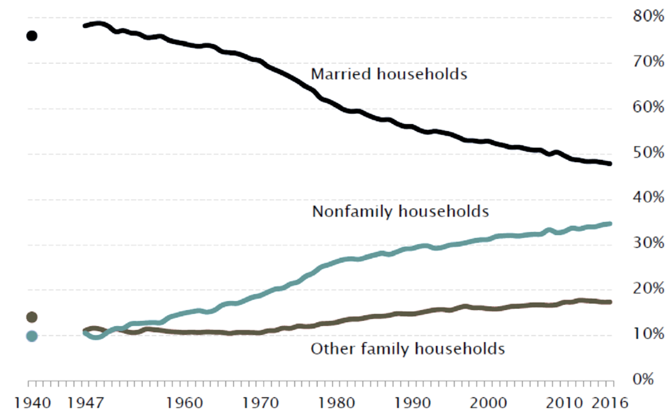
Apartments have long durability in demand because:

- They serve a basic need that will never go away.
- They provide societal benefits by offering people flexible housing choices with virtually no capital required since maintenance is covered in the rent and move-in costs are relatively small.
- They have a growing renter cohort.
- People are renting for longer; investing more in experiences versus things.
- Mortgages are still challenging to access.
- Student loans constrain home purchases.
- Millennials are taking much longer to get married and have kids, which is a big catalyst for buying a home.

Figure HH-1
Percent of households by type



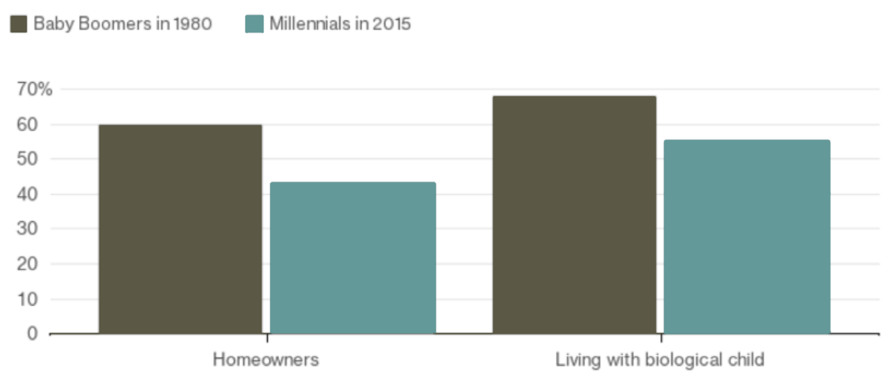
Source: U.S. Census Bureau, Decennial Census, 1940, and Current Population Survey, Annual Social and Economic Supplements, 1968 to 2016.

The reduction in marriage rates is a pretty powerful long-term trend that helps support apartment demand. The chart above shows how the percentage of married households has dropped significantly over time.

The following charts show how a much smaller percentage of millennials own homes versus baby boomers as well as having children.

Millennials Delay Getting the House and Kids

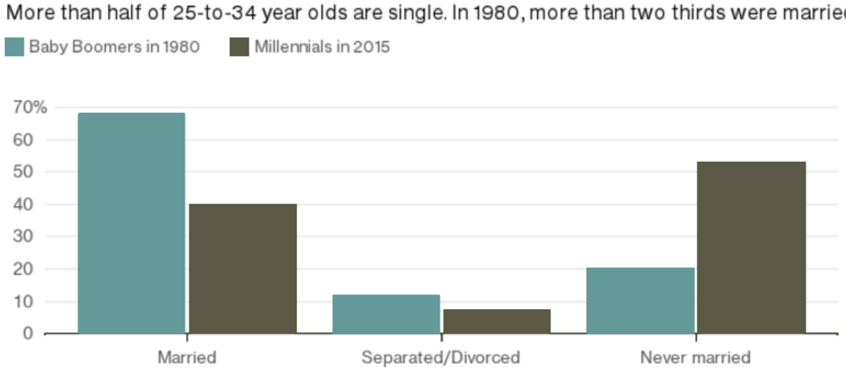
At ages 25-to-34, the vast majority of Boomers were homeowners with children.



National Center for Family & Marriage Research 2017 analysis of Census data
Bloomberg

Waiting for Marriage

More than half of 25-to-34 year olds are single. In 1980, more than two thirds were married.



National Center for Family & Marriage Research 2017 analysis of Census data
Bloomberg

The smaller millennial percentages in the chart above are heavily influenced by the very low marriage rates of millennials that is depicted.

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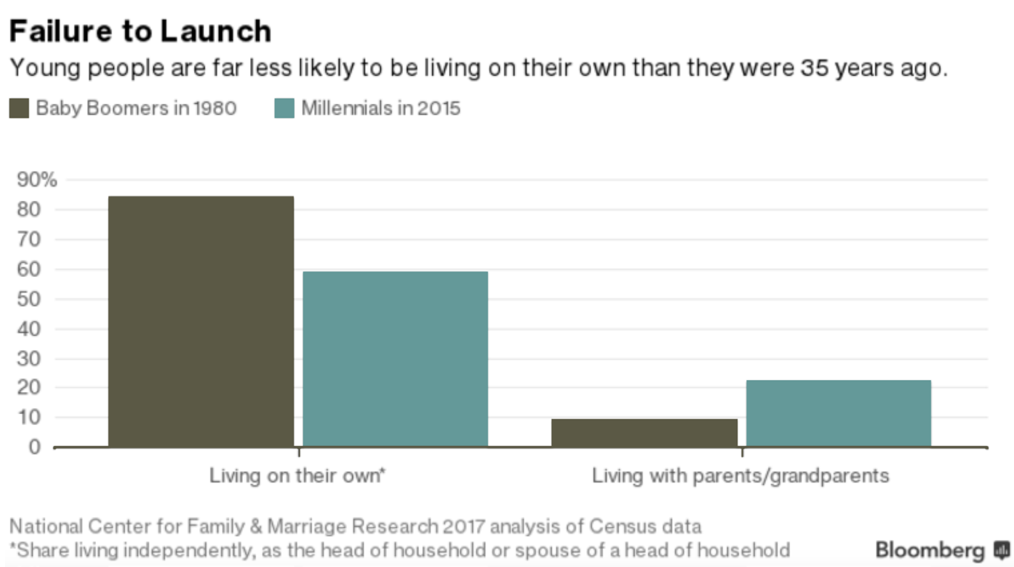
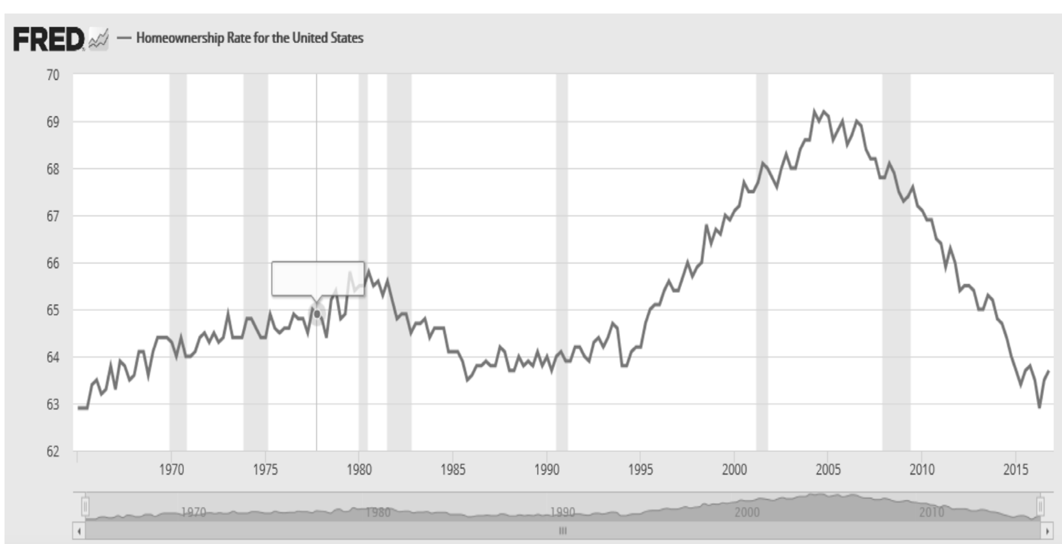
The next chart shows that if they do end up moving out of their parents' homes, then there should be a decent source of future rental demand.



All of these factors have come together in what Charlie Munger calls the Lollapalooza Effect with the outcome being a dramatic rise and fall in the homeownership rate. This effect has a corollary to biology and evolutionary systems in which a change in one part of a complex adaptive system can, through the many connections that exist, influence all other related parts, but not in any uniform or predictable way. Complex adaptive systems are very dependent on initial conditions. Changes in the inputs or rules are not correlated in a linear manner with outcomes. Housing became too easy to own and ultimately over-owned. Credit was withdrawn from the system which curtailed the number of buyers and the desire of speculators to keep investing in housing and the great unwind ensued, leading to a tremendous increase in renter households.



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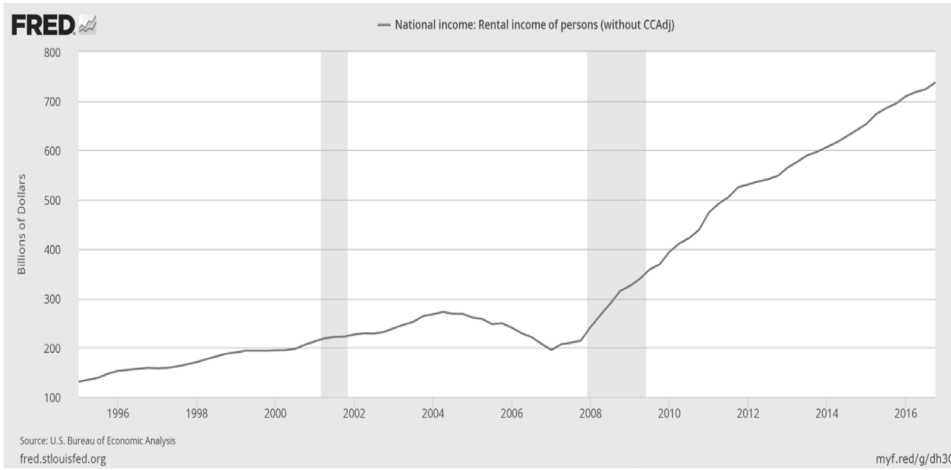
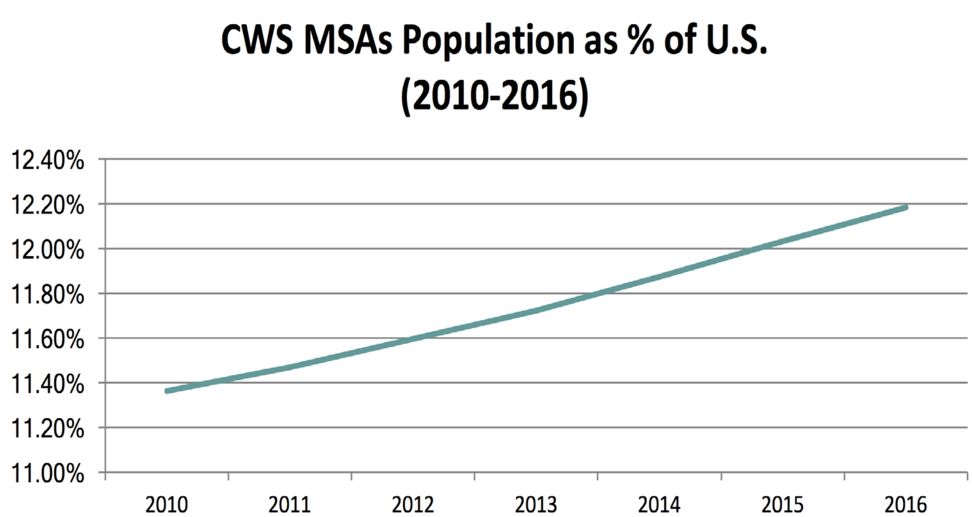
As a result of the tremendous increase in demand for rental units, our country has become more of a nation of landlords as more income is being generated by rental income.



Now that we have established that the United States population should continue to grow and this will lead to meaningful household formations and corresponding rental demand, we then have to ask if we are invested in the right places. The following are CWS' primary markets:

• Atlanta • Austin • Charlotte
• Dallas/Fort Worth • Denver
• Houston • Phoenix
• Raleigh/Durham
• San Antonio • Seattle

The following chart shows how the population of these metropolitan areas has been growing at a much faster rate than the U.S. as a whole as evidenced by its increasing share of the U.S. population.



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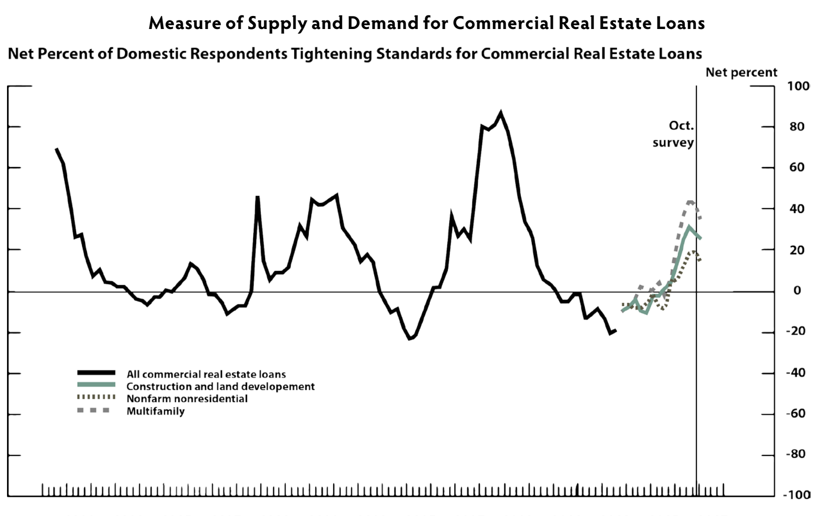
Our markets have been growing at a rate of approximately 2.7 times as fast as the nation overall between 2010 and 2016. If we assume this same relative level of growth and the average new household formed being 2.50 people (more conservative than the marginal average of 2.22 nationally) then we can produce the following table:

Population Change 2016-60	30,736,544 (1.3% per year)
Projected Household Size	2.50
Projected New Households	12,294,621
Number of Years	44
New Households per Year	279,423
2015 Permits	257,078
Permits Issued Between 3/16-2/17	280,595

It would appear that our markets should have pretty strong demand for new housing over the next four decades if these forecasts are reasonable. If approximately 40% of new households formed are renter households then this would translate to annual demand of approximately 120,000 units over the next four decades. From a supply standpoint I would expect there to be enough to meet the demand with cyclical variations based on the economy, labor availability, competition from single-family homes, and lenders' willingness to make construction loans. Right now the market is tightening up among banks for lending to apartment developers as the next two charts show.



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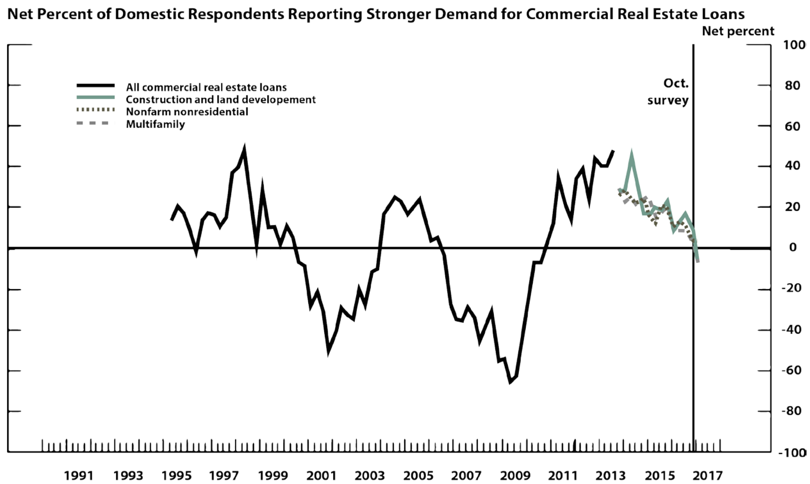
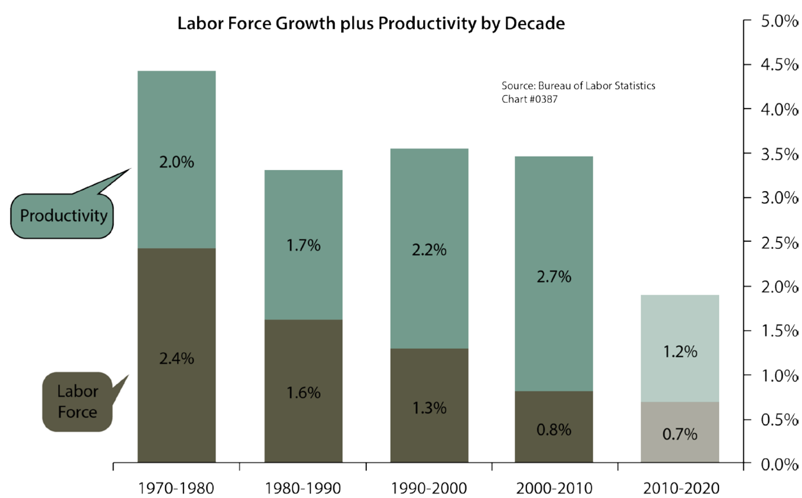


With the exception of the financial crisis of 2008-9, the multifamily lending market is pretty tight and at similar tightness as previous recessions. This has spilled over to lessening demand for multifamily loans as the second chart shows.

With demand looking to be solid over the next 40 years or so, supply is going to be somewhat challenged due to tightening lending standards and difficulties in securing construction labor, I would expect that supply and demand should fall back into balance over the next few years after being moderately oversupplied, particularly in the urban core of major cities. The last variable is interest rates which impacts the cost of capital. The following chart shows how we have some structural headwinds for rapid growth due to a slow growing labor force and subdued productivity which has been slowing quite significantly since the Great Recession. I don't see these trends changing materially which suggests to me that interest rates will remain low for many years to come.



It's been a wonderful 30 years at CWS and apartments have been very good to us over much of this time. Of course no investment moves higher in an uninterrupted, straight forward direction as there are always cyclical forces that can come into play. Despite this, I would say that apartments appear pretty well-positioned from my perspective as a solid investment option for the next 30 years.