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Quarterly Update

CWS Capital Partners LLC

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CWS

CALENDAR OF EVENTS

May 25, 2020
Memorial Day
CWS Offices Closed

June 15, 2020
2nd Quarter 2020
Est. Tax Payments Due

July 3, 2020
Independence Day (Observed)
CWS Offices Closed

July 15, 2020
2019 Federal/State Tax Filing Deadline
1st Quarter 2020
Est. Tax Payments Due

July 31, 2020
2nd Quarter 2020
Quarterly Reporting Packages Mailed

September 7, 2020
Labor Day Holiday
CWS Offices Closed

September 15, 2020
3rd Quarter 2020
Est. Tax Payments Due

October 15, 2020
2019 Tax Return Extensions Due

50 CWS Enhancing Lives Years

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WHAT DID THE FARMER SAY WHEN HIS HORSE DROPPED DEAD?

…Never did that before.

I think that is a trite, apt description about the economic and social impact of the response to COVID-19. Our economy had gone from 0 to 60 over about a seven-year period in a fairly methodical path of growth with some occasional setbacks. That all went into reverse in just a matter of weeks as the economy collapsed and not only went back to zero, but went into reverse. In two weeks nearly 10 million people filed for unemployment insurance. The leisure and hospitality industry has been particularly hit hard, as activity has virtually evaporated. And this is not an insignificant part of the economy as it represents about 11% of economic output. Air travel is now essentially zero as millions of people are no longer traveling for work or taking vacations. For example, JetBlue said that their daily number of flyers dropped from 125,000 to 7,000. The circulation of people and money is for all intents and purposes no longer.

The government has stepped in quite aggressively with the first phase of the stimulus package, which is designed to create a financial bridge for millions of people until they can get back to circulating again. In addition, the Federal Reserve has implemented aggressive monetary actions in order to create liquidity for various aspects of the bond market, provide dollars

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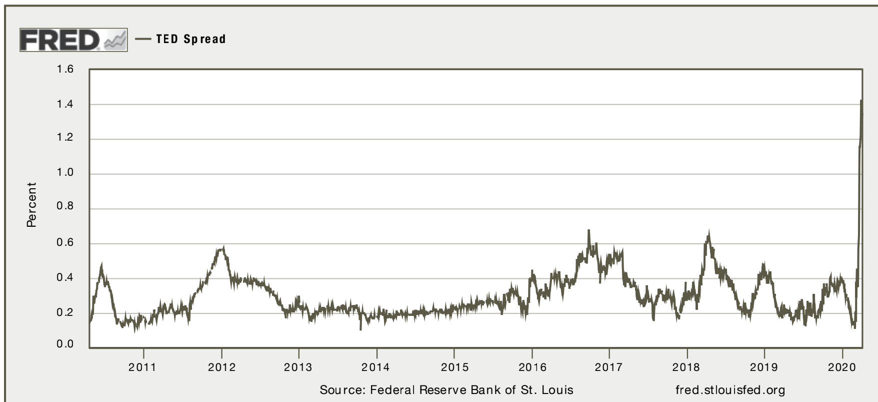
to other central banks to try to satisfy the enormous global demand for dollars, as well as lowering short-term interest rates. The credit markets have thawed a bit now that the Fed has intervened but the banking system remains under stress as corporations have drawn down nearly $300 billion from their credit lines. This in turn has put a lot of pressure on banks to retain dollars. The shortage of dollars around the world is quite acute and this is reflecting in the dollar's exchange rate going through the roof as the following graph shows.

One can see that during the Great Recession the dollar appreciated rapidly, albeit from a lower level, whereas now it is rising from an already high level which will make U.S. exports less competitive and put great pressure on foreign firms that have borrowed in dollars and must now access them by exchanging less valuable currency to repay their debts. This is why the Fed has expanded its dollar swap lines with foreign central banks.



An indicator of stress in the banking system is the premium banks pay to borrow from each other for three months versus risk-free three-month Treasury bills. One can see from the following chart that after many years of being in a range of approximately 0.2% to 0.6%, the TED Spread, as this premium is known, exploded higher to approximately 1.40%. This is something I monitor closely. It is still far below the Great Recession levels but its jump shows how quickly the economy and credit conditions changed virtually overnight.

From an apartment standpoint, the stimulus package has required any borrower of Fannie Mae, Freddie Mac, or HUD to put a halt to all evictions for four months and to not charge late fees for residents. This has created a risky incentive for residents to stop paying or stretch out their payments over a longer period of time. Fortunately, our April collections came in relatively strong although we are expecting more challenges in May. Out of roughly 30,000 units, we had a little more than 500 residents ask us to restructure their payments, and this is something that we have been working on. We expect this number to increase as time goes by, and possibly significantly.

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Our relatively strong collections for April is a byproduct of having properties that cater to more of a higher income resident base versus workforce housing. The pricing differential between those two categories of apartments really narrowed among investors because there was a strong belief that workforce housing was insulated from competition because new product that was being built required significantly higher rents and that it was going to be difficult for people to buy homes and, as a result, the risk premium dropped significantly despite the more capital-intensive nature of these older communities and the potential economic risk associated with a downturn. Now this has come into play so it will be interesting to see how those class B and C communities fair in terms of collections relative to those that cater to a higher income resident base which is more typical for CWS.

Our distribution policy for this quarter is one which is generally business as usual since it represents first quarter activity. Going forward, we will take a much harder look at our distributions based on our collections and requests for payment plans and making sure that we have sufficient working capital to help us manage through what we expect to be challenging times. We also have the opportunity to enter into forbearance agreements with Fannie Mae and Freddie Mac. These agreements, if exercised, allow borrowers to defer making mortgage payments for three consecutive months in exchange for repaying these deferrals over one year. If we were to enter into forbearance then we would be prohibited from making investor distributions, which is something we want to avoid.

We will be cutting back on non-essential capital expenditures to preserve cash and to lower our break-even occupancy rates. One of the positive contributors to this will be our reliance on floating-rate loans as approximately 77% of the dollar volume of our loans are variable rate. On a property basis, we have 82 properties with floating-rate loans and 21 with fixed-rate loans. The weighted-average interest rate on the floating-rate loans is about 2.66% with the real prospect of that going lower based on the forward curve, which anticipates LIBOR dropping roughly another 0.7%, which would then move our average cost of funds to slightly under 2%. This will be extremely beneficial for us in a much more challenging economic environment as it would lower our break-even occupancy by an average of 5% to 7% for most properties.

We think that the rest of 2020 and 2021 will be challenging as the economy tries to regain its footing, and no one really knows how it's going to look when it does get back on its feet and how long it will take. I have a hard time seeing this being a short snapback recovery because I would think that until we have a vaccine or herd immunity it's going to be one step forward and maybe two backwards. If we let people return to congregating and socializing too soon and we have more waves of transmission then this will put more pressure on the hospital system unless we have significantly more ventilators and personal protective equipment as well as ICU beds. If this is the case then we will be able to deal with the trade-off between the economy and public health in a little more balanced fashion. Although I do believe that low airfares and gas prices will help incentivize people to travel again, I see it as more of a slow build up than a quick snapback. I also think that the Fed will be slow to

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remove its stimulus recognizing how fragile the recovery might be. As a result, I think interest rates are going to stay quite low. We have three-month treasury bills near zero and 10-year treasury yields less than 1% which is quite extraordinary on a historical basis, although on a relative basis with other countries having negative rates it's not so out of line. I have been in the camp that when the next recession hit we would have very low long-term rates and now this is obviously upon us.

As I alluded to earlier, we have been positioning ourselves pretty well for a downturn, albeit not one this fast, and this is indeed unprecedented. We have invested in our properties to keep them in good condition while also building up healthy cash balances. We do have some properties with some retail leases but, in general, they represent a small percentage of our revenues. Fortunately, we operate an essential business, housing, so we feel that apartments should come out fairly well when all is said and done. And when you overlay our floating-rate debt and the flexibility that this has provided us and the prospect for continued lower interest rates, which will give us a bit of a hedge in terms of not needing as high a level of occupancy to satisfy all of our obligations in the event that things get worse before they get better, we feel like we are relatively well-positioned to weather the storm.

After this quarter, we will be analyzing each asset very carefully to determine the optimal capital management and distribution actions. Our number one goal is to avoid capital calls. The second is to avoid having to go into forbearance with Freddie Mac and Fannie Mae, while the third is to preserve our distributions. We want to come out of this with our employees and residents healthy, our properties in very good condition, our reputation with our lenders as being stellar because we didn't have to utilize forbearance, and being a safe haven investment for our investors that provided them with highly valuable dividends at a time when other businesses were not able to do so. These are aspirational goals and we may not always succeed, but we will be focused intently on doing so.

We are clearly now operating under very challenging circumstances and we appreciate your understanding and patience and we will do our best to communicate pertinent information as we deem it necessary. And while we don't like to have a volatile dividend stream, we have no choice but to look at each and every property with a fresh set of eyes each quarter to determine whether distributions can be sustained or whether they need to be reduced, or even eliminated. The ones most at risk are properties with fixed-rate, amortizing loans while, conversely, those least at risk, are ones with variable-rate, interest-only loans with low break-even occupancy rates and are comprised of more of a white collar resident base.

Confucius said, "May you live in interesting times." I don't think there's any question that we are in some of the most interesting times that I can remember. We have adopted a very focused and competitive mindset that sees this as an extraordinary challenge but one that we are intensely focused on coming out on top of. We intend to set ourselves apart and we are doing all we can to position ourselves to come out of this stronger and wiser. We are looking forward to sharing this journey together and we deeply appreciate your support.