Volume 36, No. 1, April 29, 2022

QUARTERLY UPDATE
CWS CAPITAL PARTNERS LLC

CWS Capital Partners LLC

CWS

CALENDAR OF EVENTS

May 17, 2022
CWS Annual Investor Meeting
Zoom Webinar

May 30, 2022
Memorial Day Holiday
CWS Offices Closed

June 15, 2022
2nd Quarter 2022
2nd Quarter 2022 Est. Tax Payments Due

July 4, 2022
Independence Day Holiday
CWS Offices Closed

July 29, 2022
2nd Quarter 2022
Quarterly Reporting Packages Mailed

September 5, 2022
Labor Day Holiday
CWS Offices Closed

September 15, 2022
3rd Quarter 2022
Estimated Tax Payments Due

50 CWS Enhancing Lives Years

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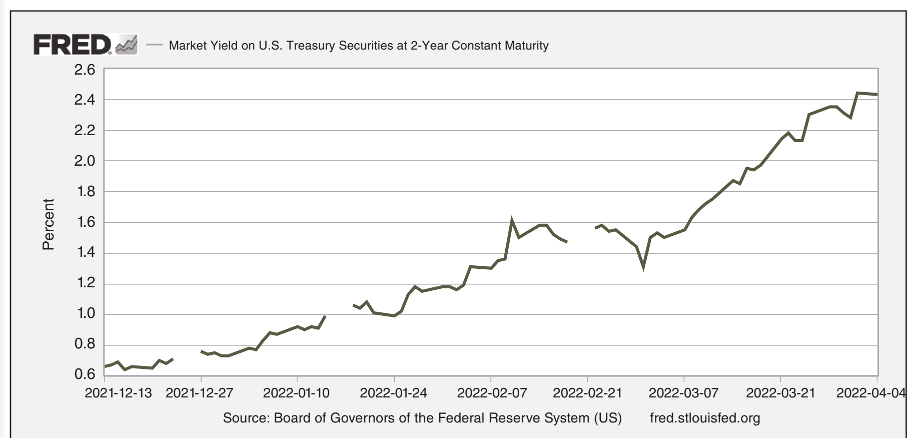
STRESS FOR SUCCESS

By Gary Carmell

In last quarter's article I discussed how the operational trends we were experiencing were quite positive and that higher revenues should help offset rising interest rates that would impact our variable-rate loans. And while the operational performance continues to be quite strong as evidenced by our first quarter portfolio generating a 16.8% increase in rents for units that have been vacated and re-leased and 12% for renewed leases, interest rates have shot up and will impact our variable-rate loans more than the revenue improvement in the short to medium term. This chart shows the meteoric rise in the two-year Treasury yield since December.



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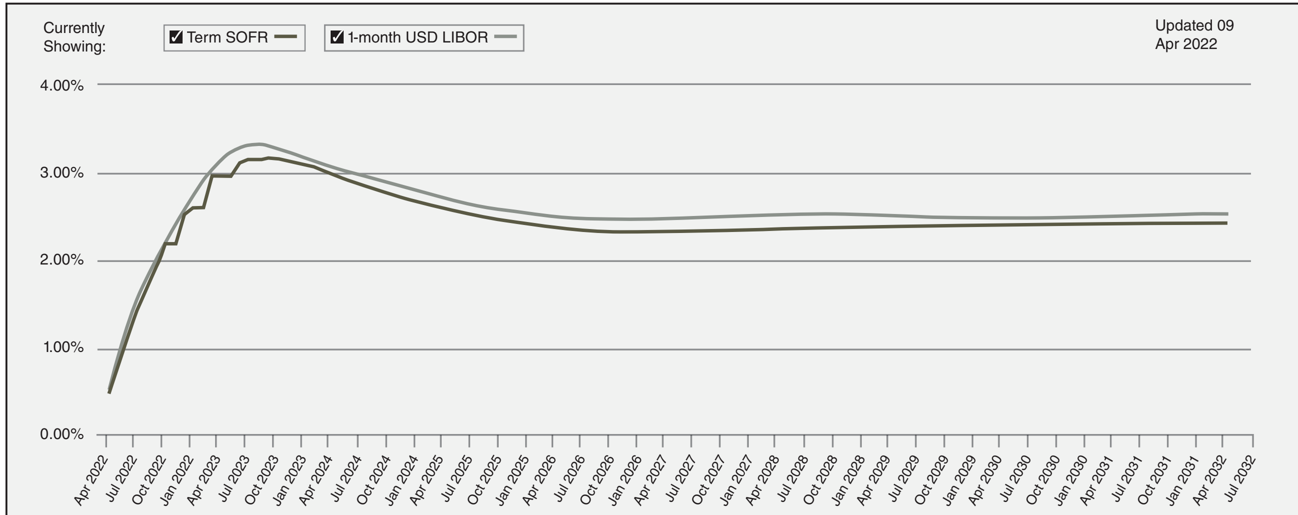
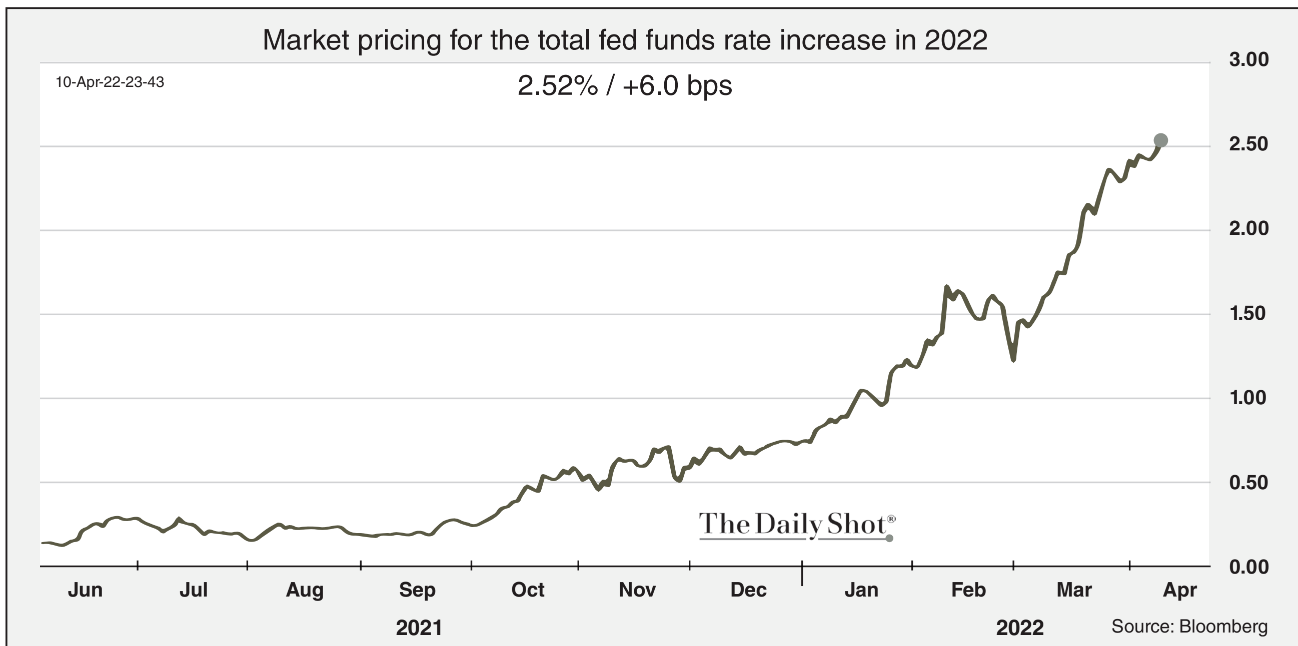
This yield is a good proxy for future short-term rates and has gone up by nearly 2% in approximately four months. This dramatic increase in rates is in response to a much more hawkish Fed that is now focused on fighting inflation by curtailing demand via tighter monetary policy.

The next chart produced by Chatham Financial shows the forward curve for two key indices in which virtually all of our variable-rate loans are based: 30-day LIBOR and SOFR.



One can see that it shows a very sharp increase between now and August 2023 with 30-day LIBOR priced in to be 3.32% and then coming down after that. The following chart shows how investors have priced in much more rapid and cumulative rate increases for 2022. In late 2021, the projection was for one increase of 0.25%. Now it's multiple increases (a few of which will be 0.50%) for a total of 2.50%.



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When last quarter's article was published the estimate was for two increases totaling 0.50%. Fed Chairman Jay Powell has pivoted again. He made the opposite shift in late 2018 when he went from hawkish to dovish virtually overnight and he has now gone from saying inflation was a transitory issue to it now being the Fed's preeminent concern. Since we are tied to the hip of Fed policy given the large percentage of variable-rate loans we have at CWS, we have to pivot in our thinking and planning as well.

We do our best to be very cognizant of downside risks so that we can remain healthy and on the playing field through all cycles. This doesn't mean there will not be disappointment resulting from cuts in distributions which are inevitable if one's debt service goes up 250% from trough to peak. On the other hand, we're playing for the long-term and, along with the market, I think the Fed will not be able to keep rates at the peak priced in and it will have to cut rates shortly thereafter. With that being said, it's very important that we be constantly analyzing how our portfolio does under this higher interest rate environment and stress test our properties to see what their projected cash generation is based on higher rates and assuming no improvement in operating performance.

From April 2021 through March 2022, 30-day LIBOR averaged approximately 0.14%, which resulted in the average interest rate of our same store variable-rate portfolio (properties we have owned for the full 12 months) being 1.81%. As a frame of reference, our May payments will be based on a 30-day LIBOR value of approximately 0.45% which will bring our average rate up to approximately 2.16%. Although we are under no illusion that our future rates won't be higher, we are still quite a bit below new fixed-rate loans which are in the 4.25% to 4.50% range.

With rates going higher we need to evaluate our cash flow based on 30-day LIBOR in the 3.00% range. I put together the following analysis to see how much cushion we have above our debt service assuming 30-day LIBOR/SOFR averages 3.00% as compared to the last 12 months for our variable-rate loans. I also show how these compare to our fixed-rate loans.

	Variable	Fixed
Last 12 months DSCR	3.77	1.52
DSCR Full Payment at 3% Index	1.51	1.52

One can see from the table above that our variable rate portfolio over the last 12 months has been able to cover debt service from property cash flow by almost 4 to 1. This is substantially higher than our fixed-rate properties which are approximately 1.5 to 1. Assuming LIBOR goes to 3.00% then our coverage ratio drops to 1.51, which is essentially the same as our fixed-rate portfolio. It is just this scenario that led us to finance our properties the way we did. It has given us a hedge when the economy contracts and the Fed lowers rates and our revenues are at risk of following suit, while also giving us a lower average cost of funds than fixed-rate loans with the added benefit of much more financially manageable prepayment penalties.

Of course all of that is well and good but people want to know "what have you done for

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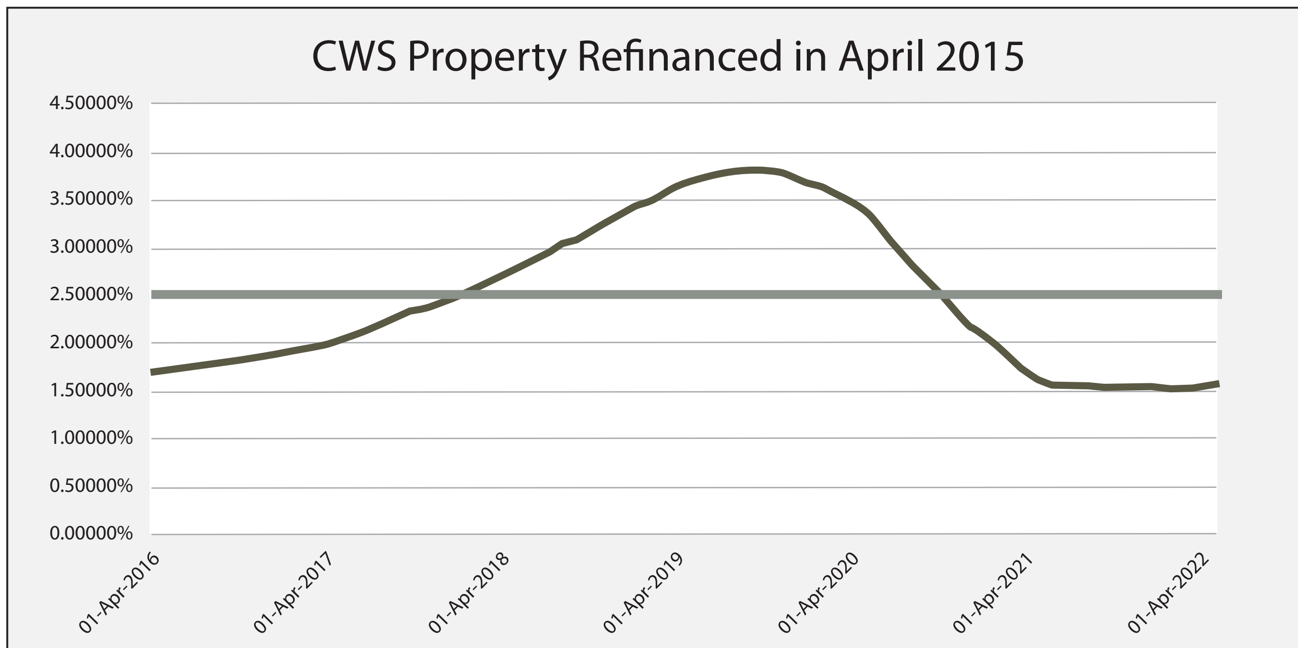
me lately?" Shouldn't we have fixed our loans so we don't have to run the risk of having our distributions lowered? My response to that is that our distributions would never have gotten as high as they did without us being overwhelmingly variable. It also gave us a tremendous hedge when Covid hit in the event our operational performance didn't hold up like it did.

In 2015 we refinanced 18 loans, some of which we still have today. This is a good dataset from which to compare as we now have seven years of information to analyze. All the loans were variable and many of them had a spread of 1.44% over 30-day LIBOR. The following chart shows the rolling 12-month interest rate paid by one of our Austin properties as well as the average for the seven years. I picked this one because it had one of the lowest fixed-rate equivalents of the 18 loans. In other words, I wanted to compare it to the lowest fixed-rate loan we could have put in place instead. The available rate to us for this property was 3.25% for 10 years at the time the loan was originated.



This loan hit a peak of approximately 3.81% and a low of 1.53% (both on rolling 12 months), while averaging 2.50% during the seven years. We have beaten the fixed-rate alternative by 0.75% per year, or a cumulative 5.25%, which is equivalent to approximately 12% of the equity invested, or close to 2% more per year in cash flow. 2% may not sound like a lot of return differential per year but if that gap can remain in place for a number of years, then the compounding effect can be quite impressive. We have also preserved great option value by having a very manageable prepayment penalty which gave us the flexibility to sell or refinance if we had deemed either of those optimal. Finally, 30-day LIBOR would need to average 3.56% (bringing the total rate to 5.00%) for the next three years for us to end up with an average interest rate of 3.25%. I believe this is highly unlikely.

As an aside, many buyers of apartments have been utilizing much more leverage than we use at CWS and at spreads over LIBOR or SOFR that are much higher as well. We did a

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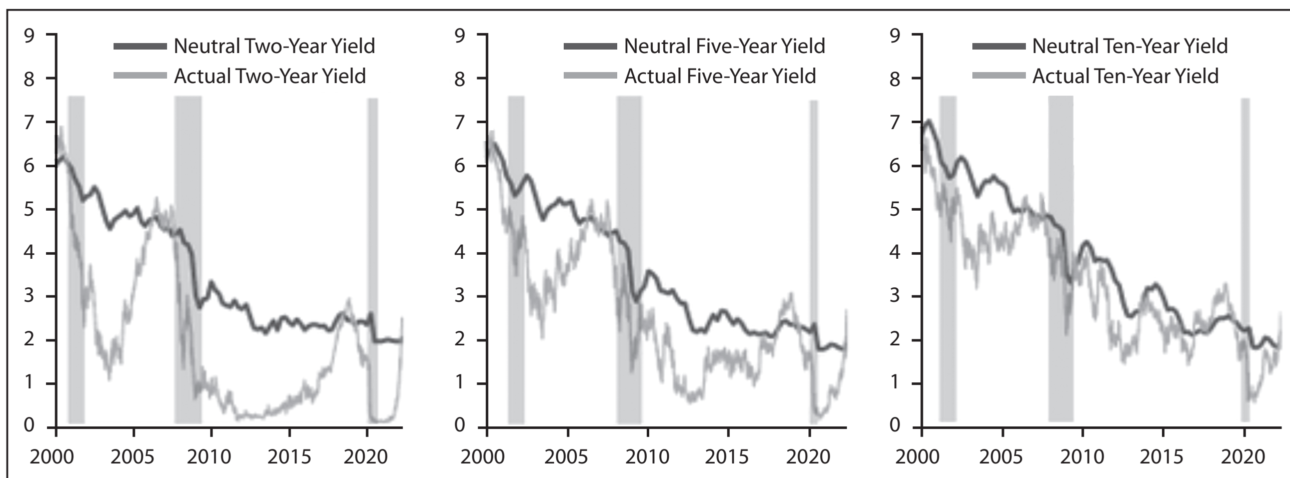
back of the envelope analysis of a portfolio of apartment loans that were recently sold to investors and estimated that, assuming no change in operating income, that if SOFR rose to approximately 2.1%, then the debt service coverage ratio for that portfolio of loans would be at 1.0 (breakeven). As a frame of reference, we estimate our floating-rate loan coverage ratio would be 1.89 at the same interest rate. Our margin of safety is much higher than many of our competitors and we think a number of them will have to be on defense when we can remain on offense, thereby potentially offering strong companies like CWS compelling acquisition opportunities.

The market is skeptical that the Fed will be able to keep rates in the 3.25% range as it forecasts long-term 30-day LIBOR to be closer to 2.50%. I am skeptical as well and I don't think the Fed will even be able to keep it that high. Assuming it does, however, this would bring our average rate closer to 4.20%, which is lower than current fixed-rate loans and would still, in many cases, give us a lower average interest rate than the prevailing fixed-rate loans at the time of origination while providing prepayment flexibility.

The reason I'm skeptical about the Fed keeping rates much above 2.50% is that I think the odds of a material economic slowdown or contraction have increased. Interest rates are already higher than the neutral rate, which is the estimate for the interest rate that would keep inflation stable and economic growth steady.



Source: @R_Perli

In addition, I follow the yield curve quite closely as it's a good predictor of future economic growth or contraction. When long rates are materially higher than short rates, investors are pricing in faster economic growth. When the opposite is the case, whereby the spread is very narrow, or even negative (inverted), the market believes that economic growth will slow, or even contract.

The following chart shows the difference between 10-year Treasury yields and 2-year yields. One can see that it compressed very rapidly, and even inverted for a short period of time, only to go positive again.

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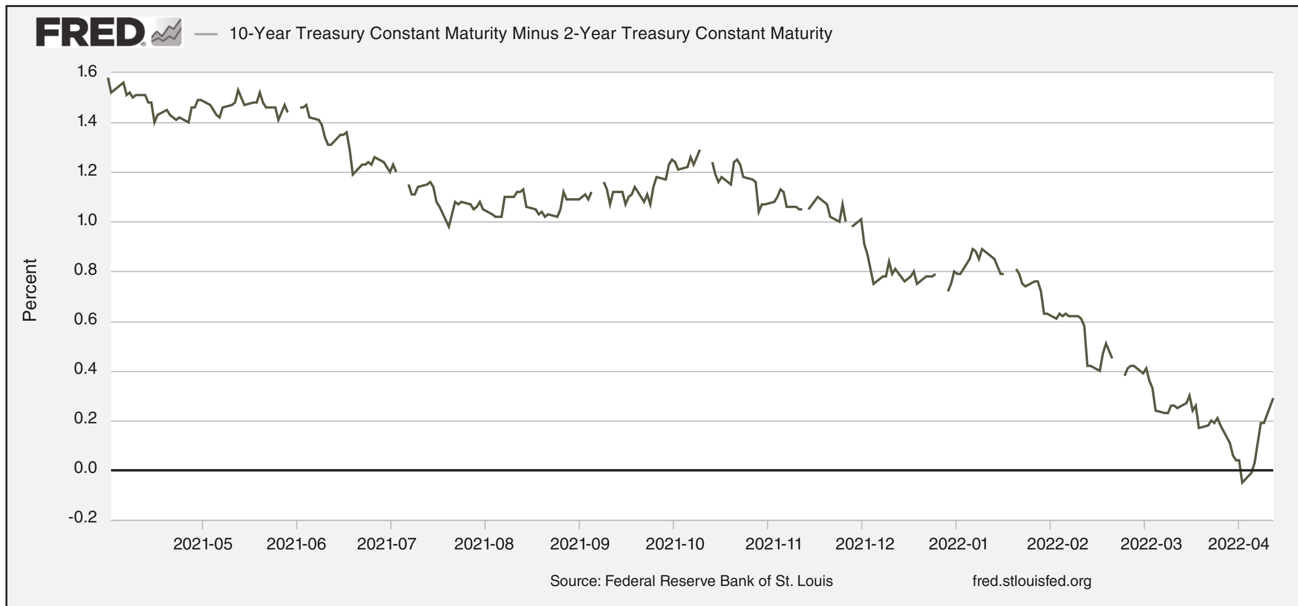
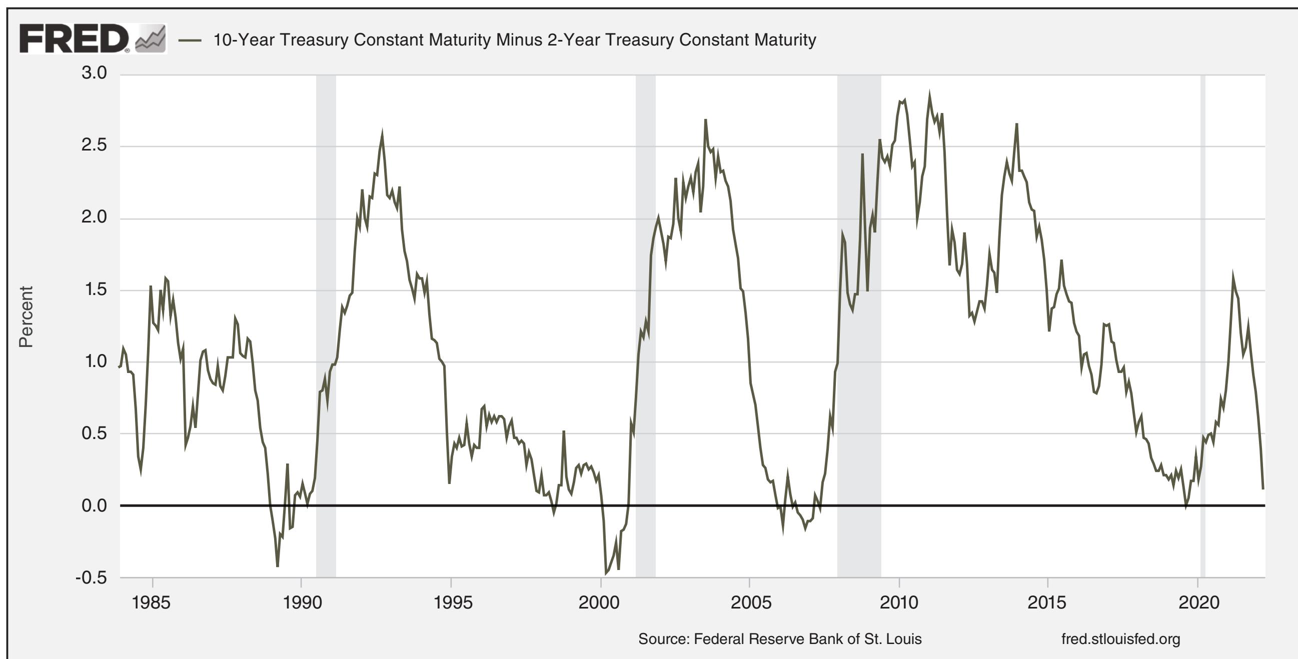


One might look at this as a positive sign for future economic growth as inverted yield curves are historically precursors to recession. And with the spread between 10s and 2s now being positive perhaps one could interpret this as a sign that future economic growth is looking more positive. Unfortunately, if history is any guide, the opposite is usually the case. The yield curve turning positive after being negative almost always foreshadows a recession.



One can see from the chart above that the last four recessions (shaded vertical columns) were all preceded by the spread between the 10s and 2s either being negative or very close to zero and then turning positive before the onset of the recession. Investors seem to be factoring in a recession some time in 2023 as the consensus forecast.

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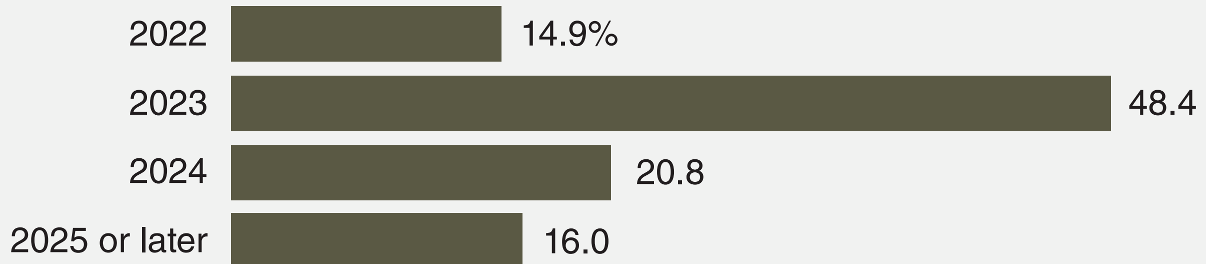
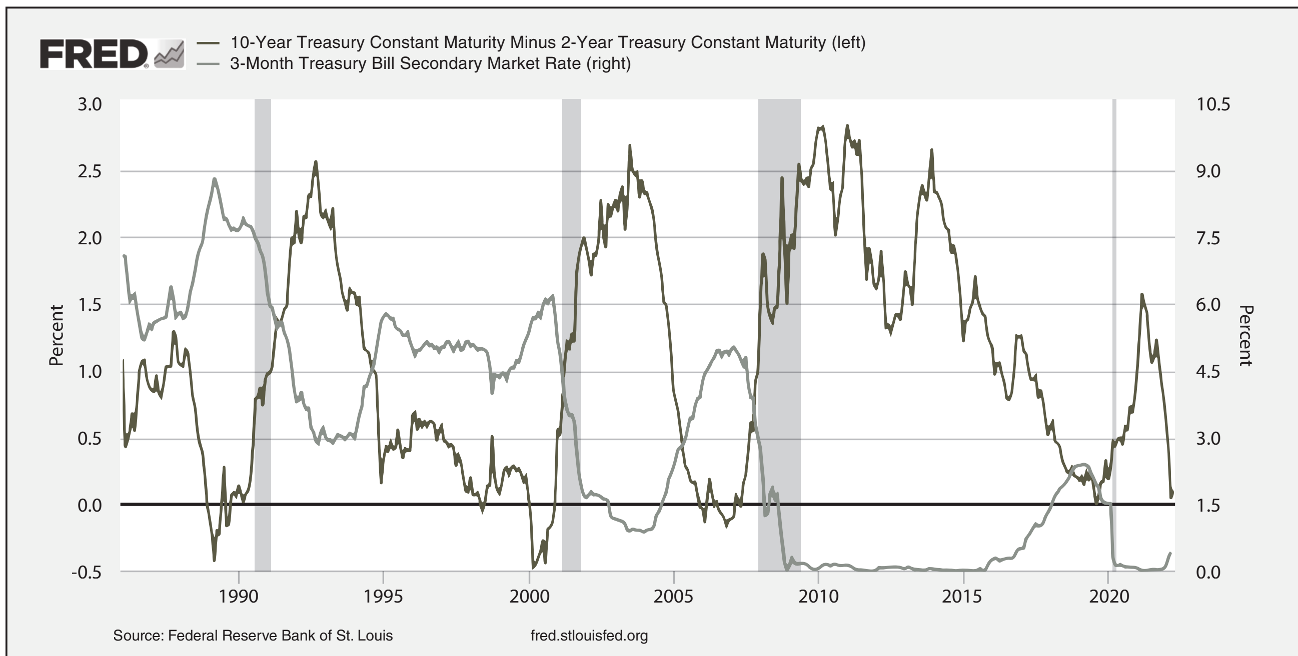


The next chart shows the spread between 10s and 2s and the 90-day T-Bill yield. What is fascinating about this interest rate hiking cycle is that it's taking place when the yield curve has inverted. The Fed usually starts cutting rates when this is the case. It has not hiked, especially aggressively, when the yield curve has been inverted or very narrow.



This is the market saying that the Fed is behind the curve in terms of fighting inflation and will act very aggressively to hike rates and tighten monetary policy, but it will break something in the financial markets or economy and then will have to cut rates again. The following chart shows the time between the last rate hike and when rate cuts ensue. The average has been six months.

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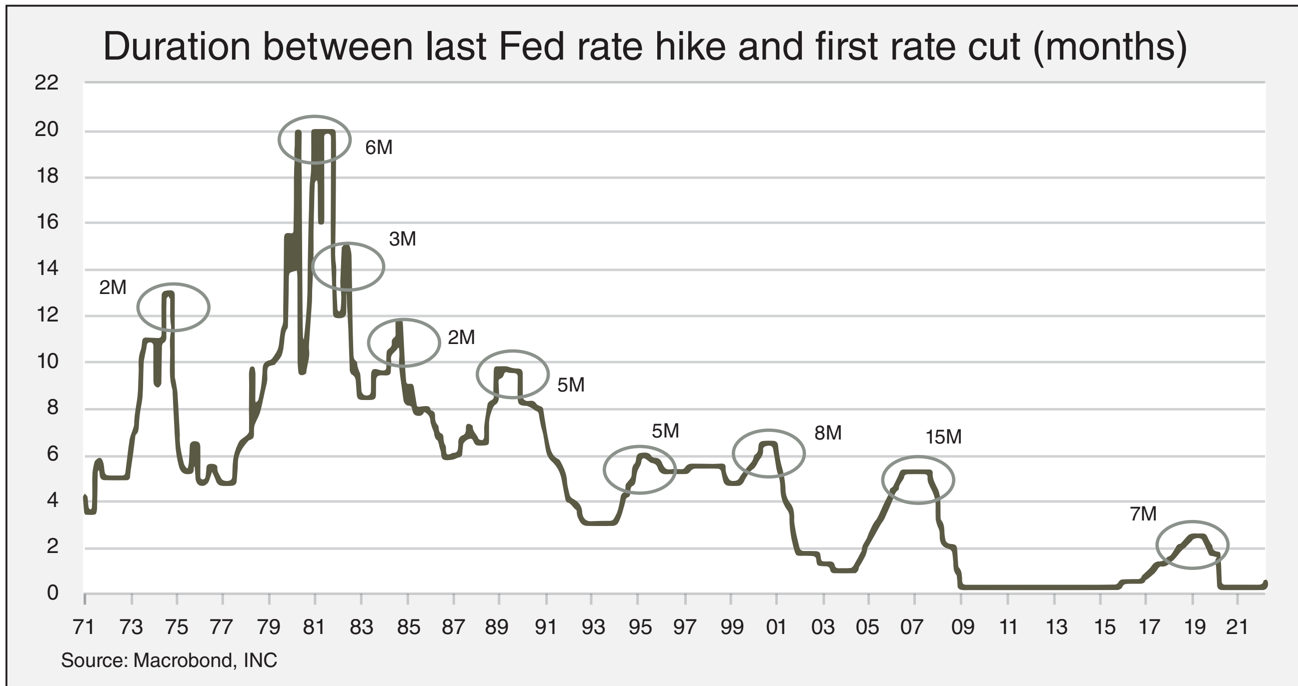
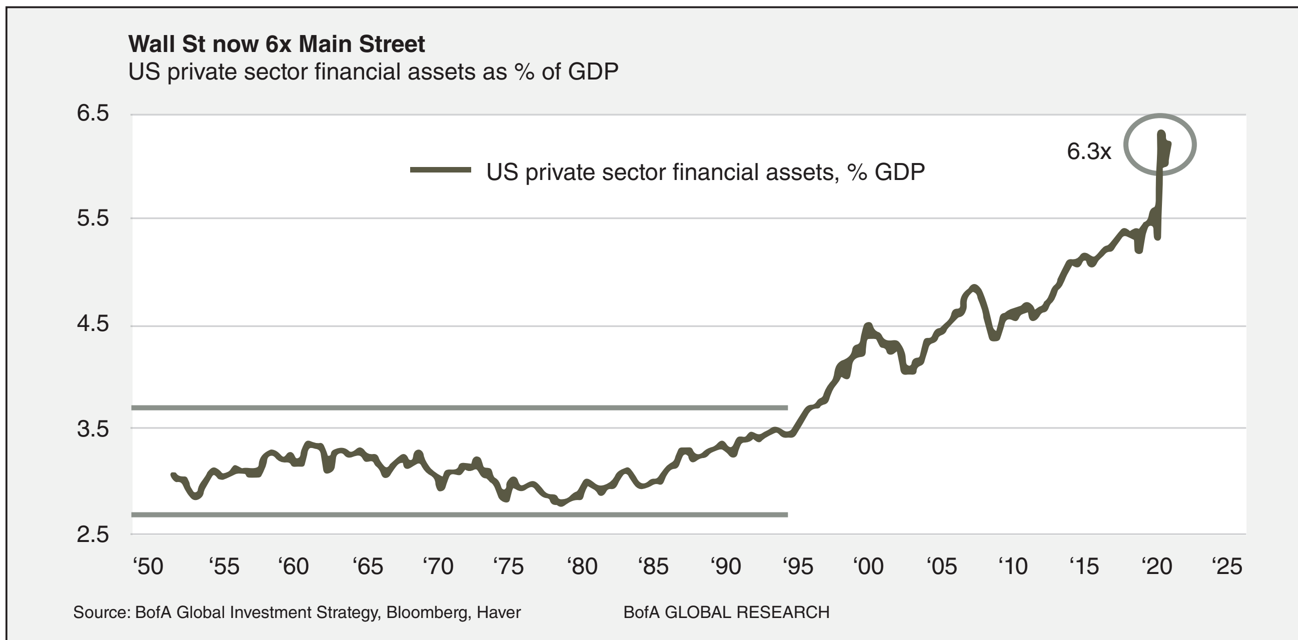


The economy has become much more "financialized" over the last 40 years, with leverage growing even more dramatically in the wake of Covid. This is why rapid rate hikes can trigger some sort of financial crisis.



With so much debt in the economy, the Fed will be challenged to raise rates much beyond 3% and keep them there. Every time the Fed tightens monetary policy, some sort of crisis unfolds.

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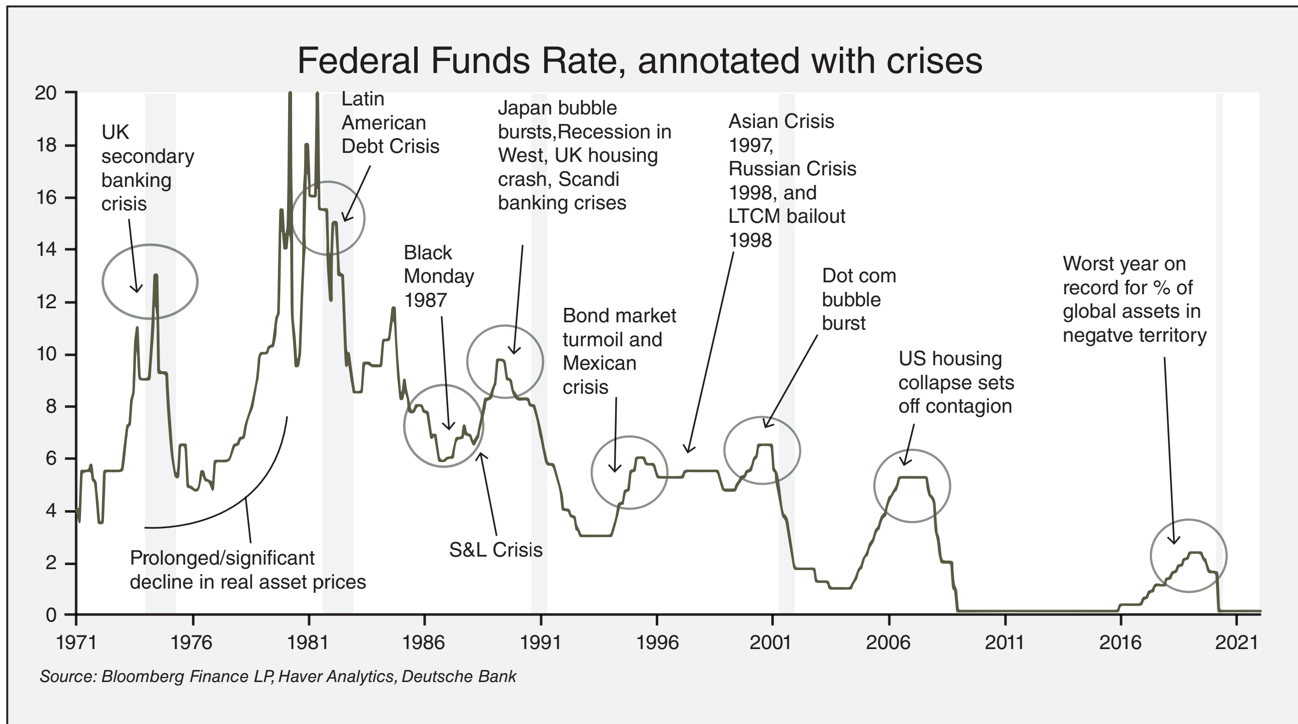

One Wall Street analyst believes that going beyond 1% will create problems for the economy. From his research he has concluded that, given the increasing leverage in the economy that comes from easing monetary policy cycles, the Fed can only tighten approximately 70% of what it loosened in the previous interest rate reduction cycle. So, for example, if the Fed lowered rates by 3%, then it can only raise them 2.1% before creating problems. In this last cycle, the Fed brought rates down to 0%. And, yet, based on analysis done by a few different economists, they have made estimates for what they call the shadow rate. This is the effective rate if interest rates could go negative based on how loose monetary conditions are.

The model this analyst from SocGen uses estimated that the shadow rate got down to -5.00%, which was an approximately 8.00% drop in the shadow rate. Based on his 70% upper limit, this would mean the Fed has 5.60% to tighten via higher rates and contracting its balance sheet by lessening its holdings of Treasuries and mortgage-backed securities. Here's a chart showing past loosening and tightening cycles. Take notice of the fact that, even after only a 0.25% increase in rates, that the Fed has effectively tightened by 2.50% already based on this hike and the market's reaction to the Fed contracting its balance sheet more rapidly than expected.

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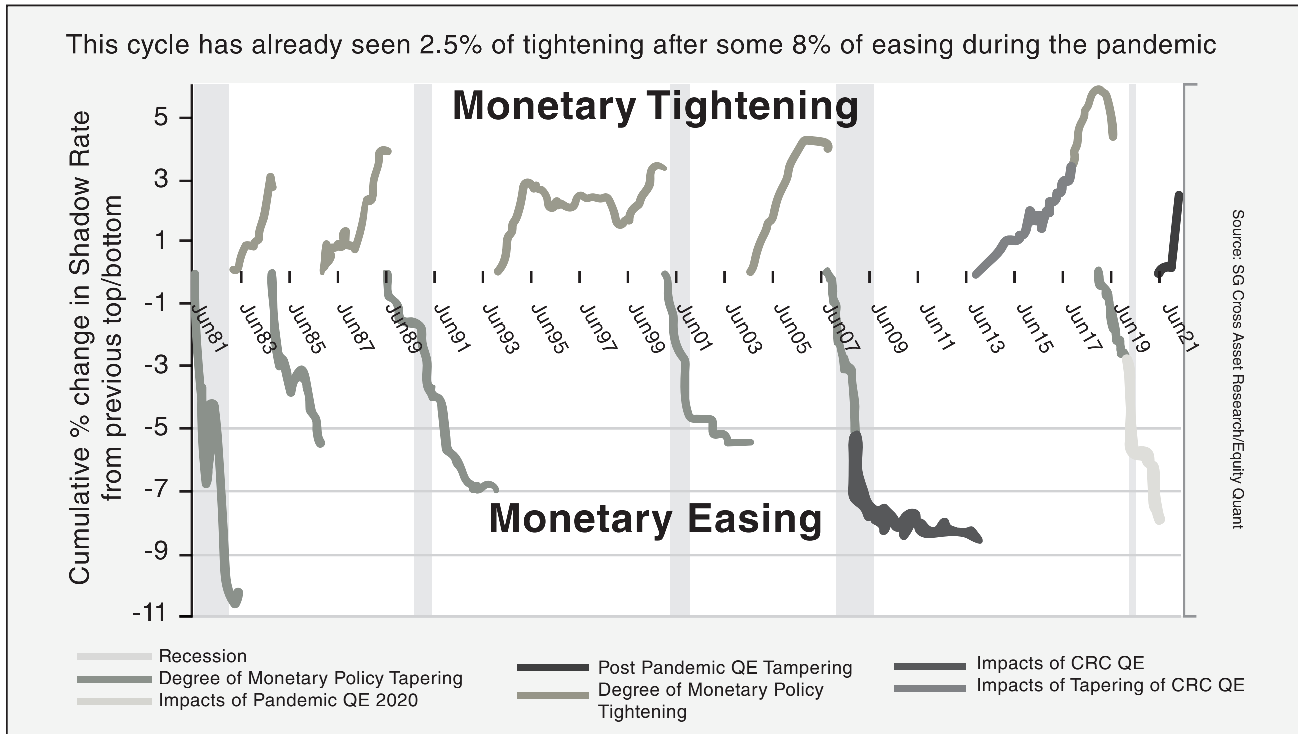
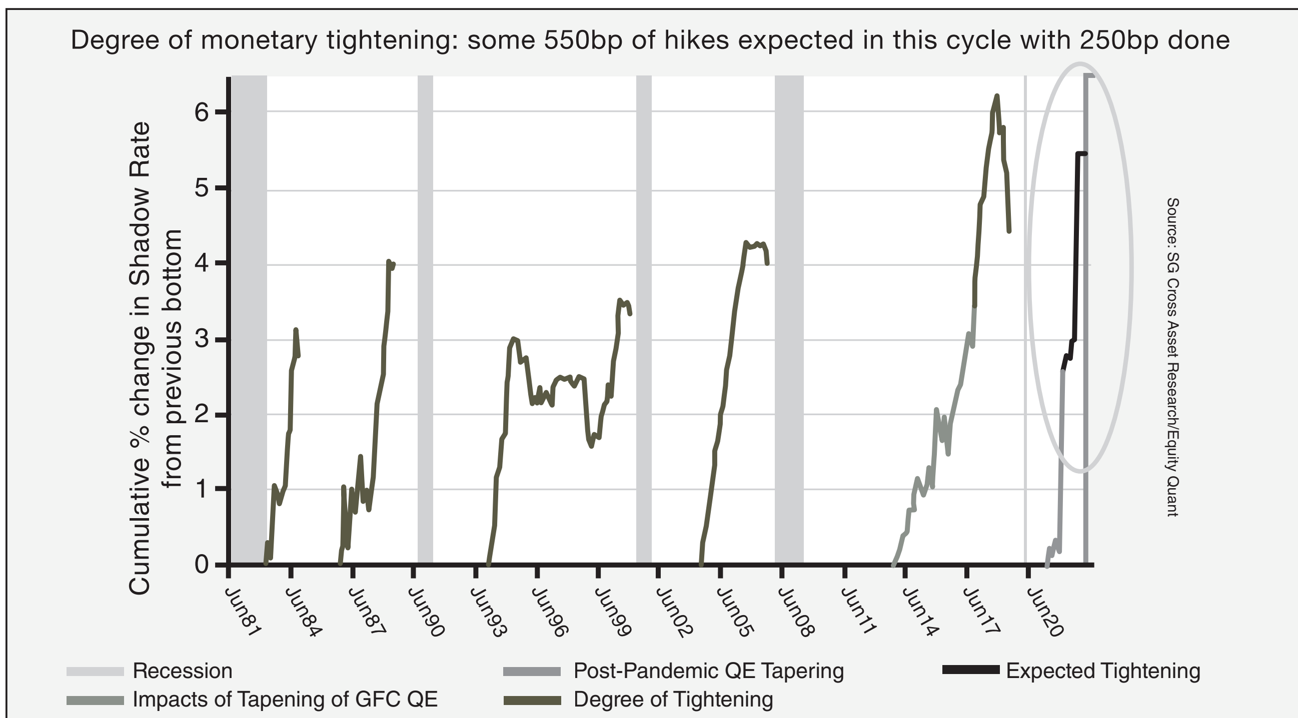


He now believes that the remaining 3% of tightening will come from 0.75% of interest rate hikes with the remaining 2.25% coming from balance sheet contraction.

This chart shows how the projected tightening in this cycle, which is far more dovish than what the market is pricing in, will still have it be one of the more significant tightening cycles. And, if he is wrong, and the Fed goes higher than 1%, then it will be the most aggressive tightening cycle of the past five.



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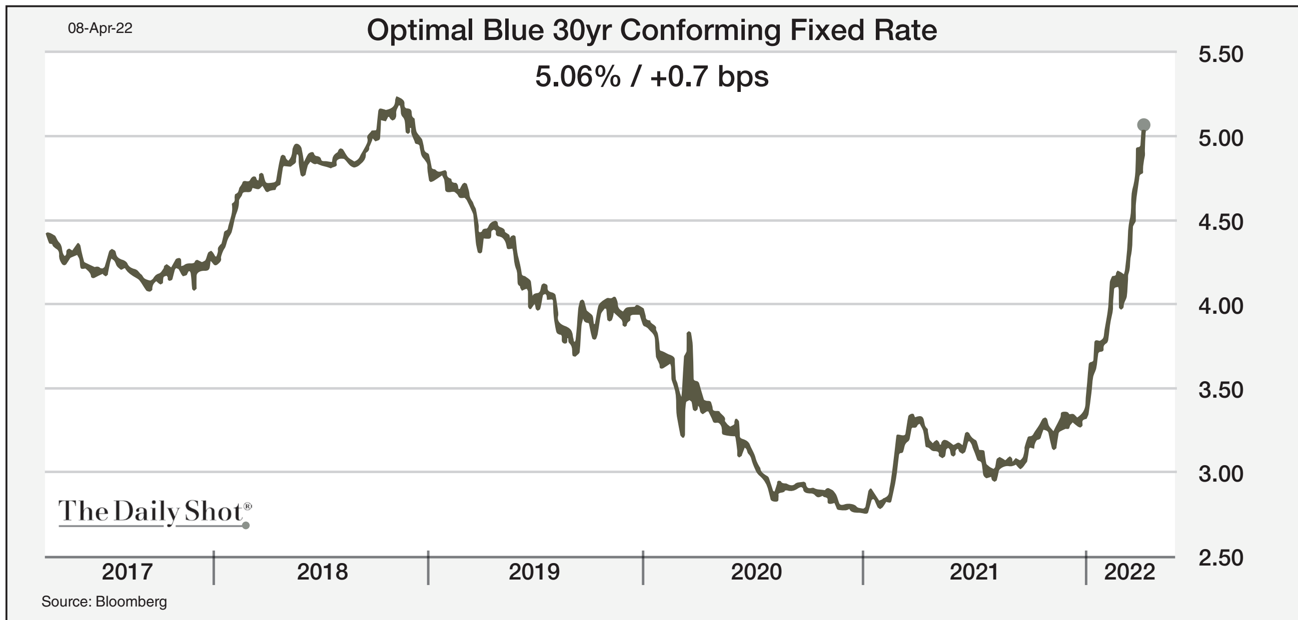
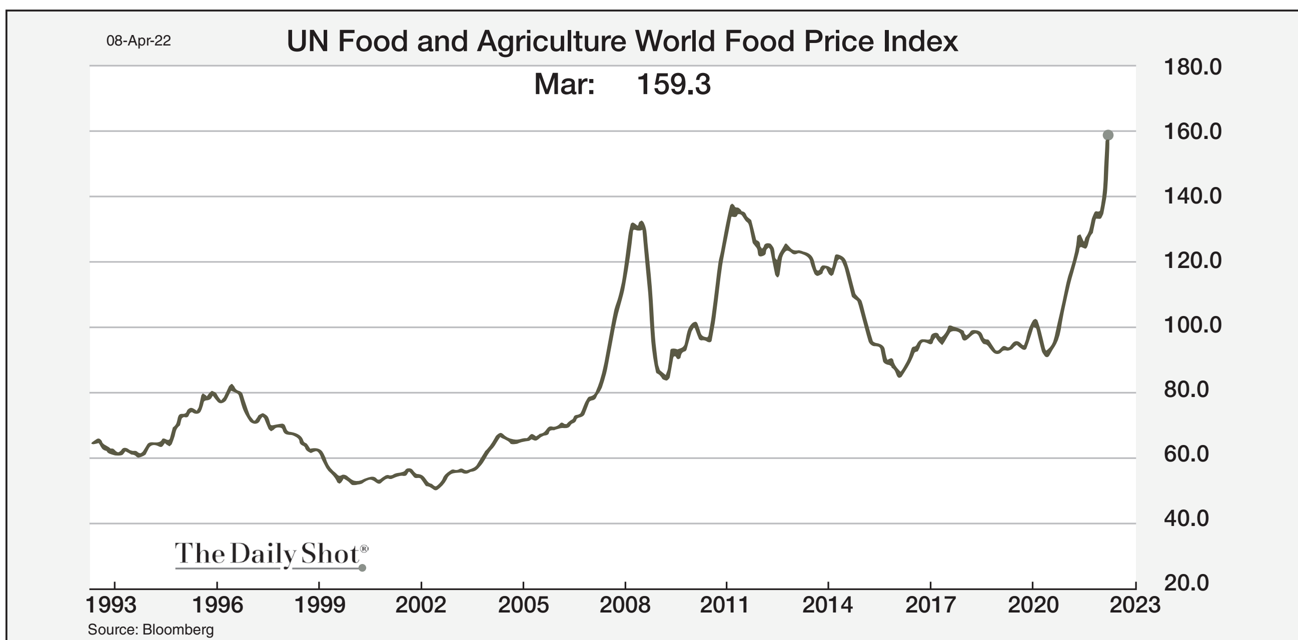
A great example of tightening financial conditions, despite the Fed having only raised rates by 0.25%, is mortgage rates. Look at how rapidly they have risen since the start of the year. There is no way this won't curtail demand as buyers now find it even more expensive to purchase a home, especially with home prices having rocketed higher during the low-rate environment. This doesn't mean that home prices still can't rise as demand is projected to exceed supply. What it will do is materially lower the rate of appreciation of home values. We think it will be very supportive of rental demand as more people get priced out of homeownership.



And if we add into the mix much higher gas prices, and food as well, the consumer is getting squeezed which doesn't bode well for future spending. This chart is not good for the prospects for social stability in poorer countries.



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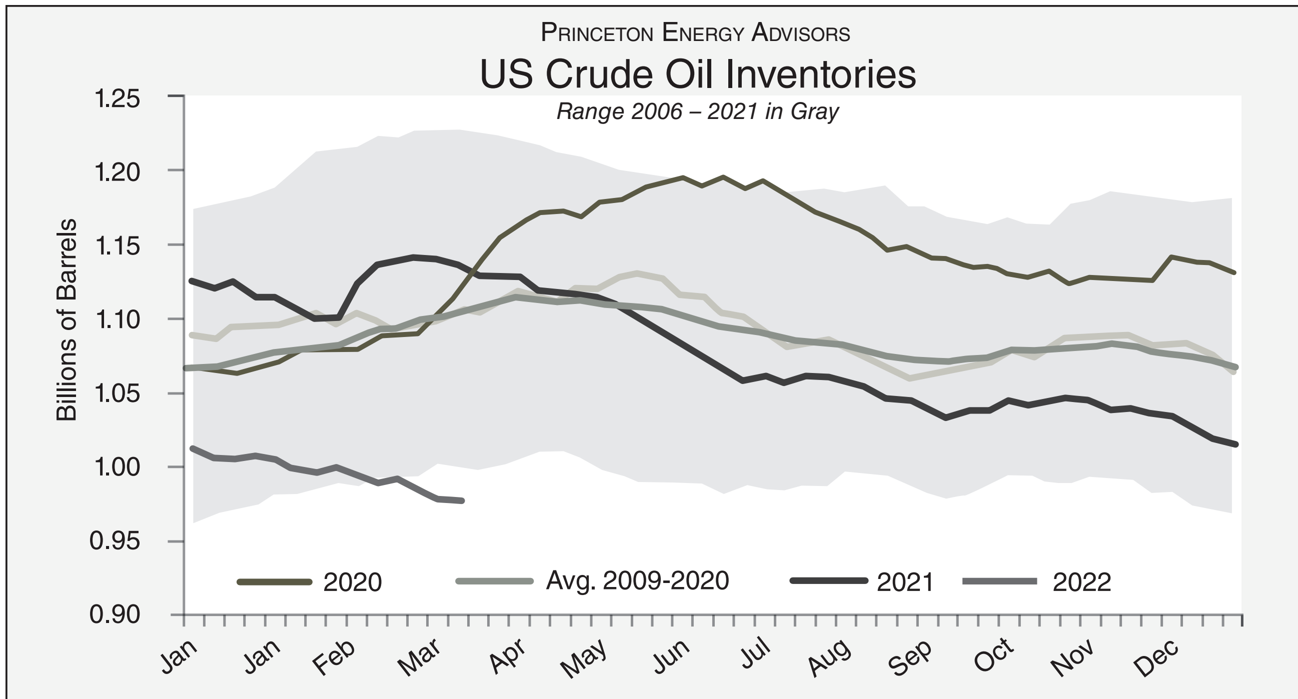
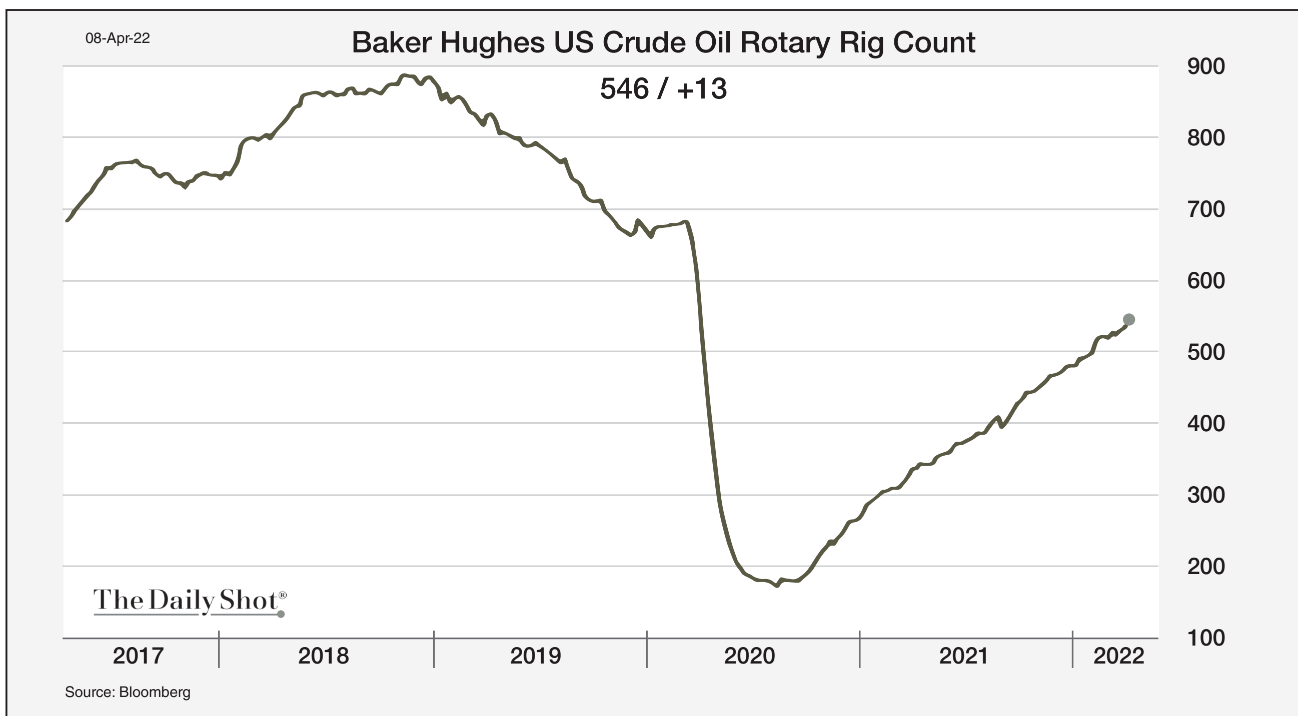
Unfortunately, it doesn't look like we're going to see the energy situation get any better, especially with the war in the Ukraine and the resulting economic sanctions against Russia, which will impact its ability to supply countries still willing to buy from them. Our crude oil inventories are very low and adding new supply is costly and time consuming due to input constraints.



The rig count is growing but is still about 33% less than it was in 2018 when oil prices were lower.



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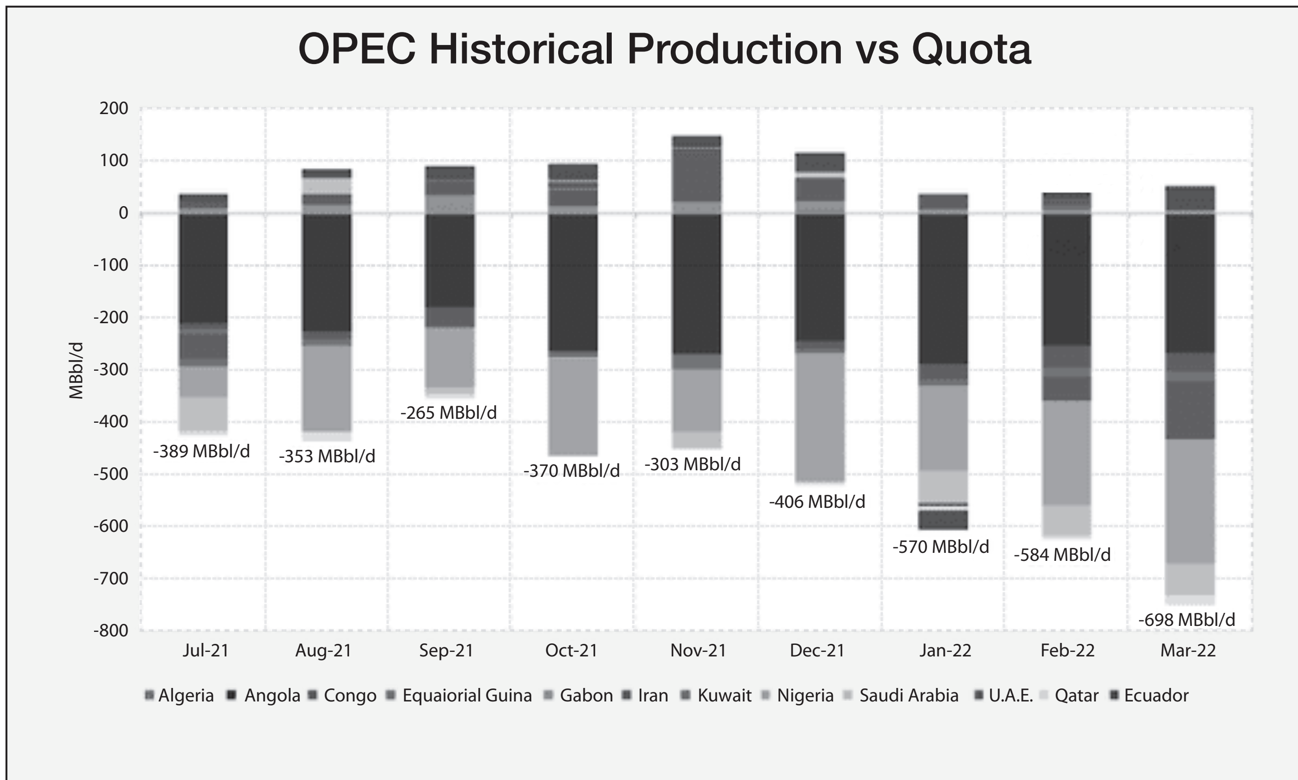
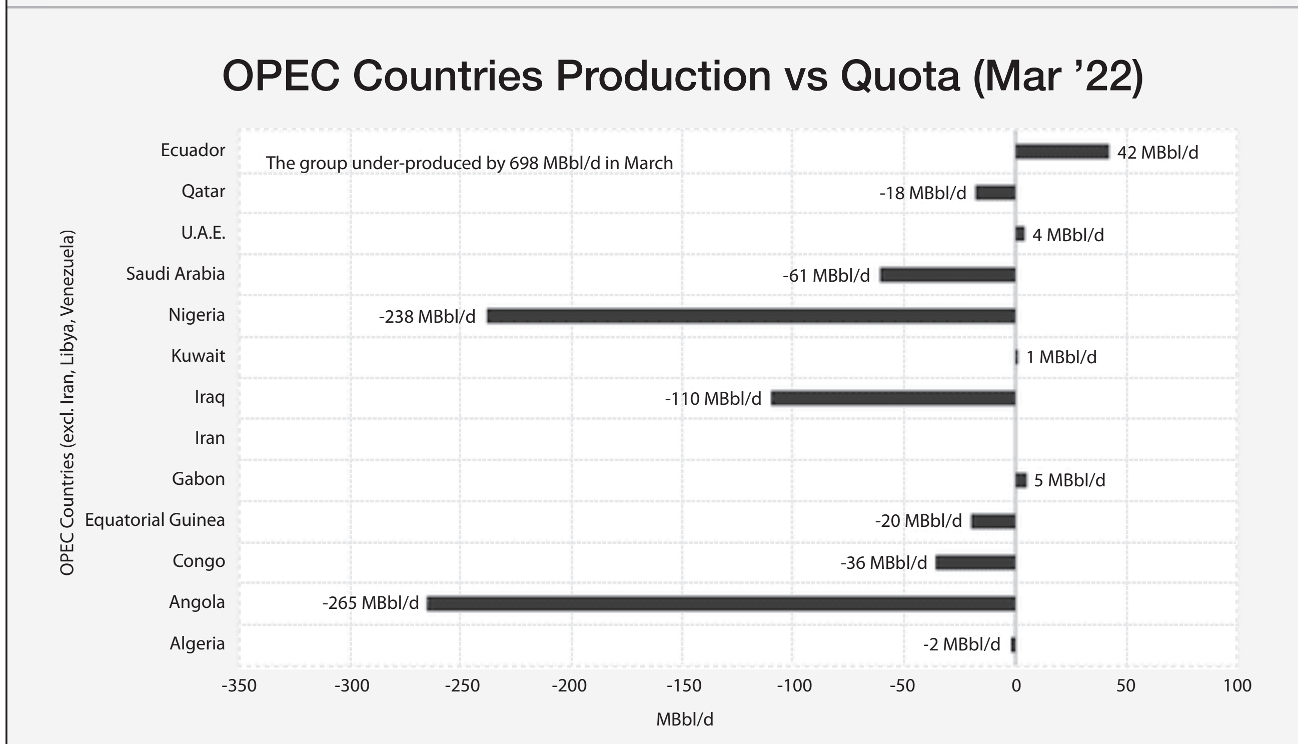
OPEC has a lot of incentives to meet its quota given how high oil prices are. And yet, most countries are falling short of their allotted quotas which has led to a shortfall of close to 700,000 barrels per day.





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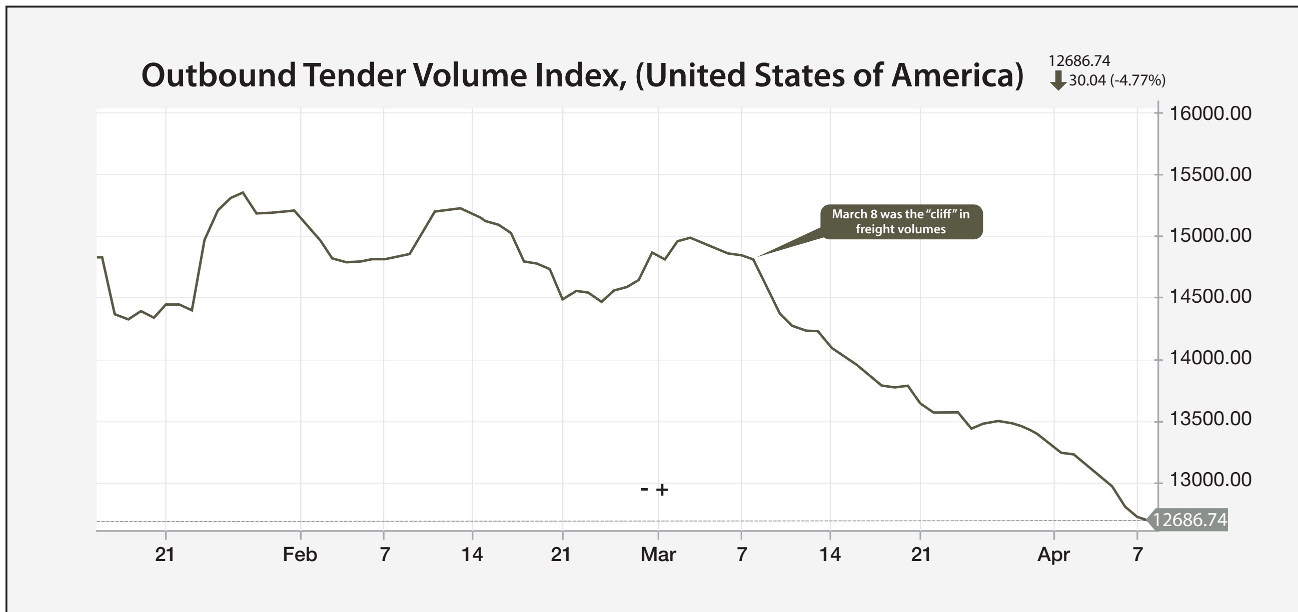
Finally, there are a few cracks already showing up in the system. Freight demand appears to be falling precipitously.

Craig Fuller
@FreightAlley

This a chart of freight demand for the US contract truckload market. March 8 was the "cliff" in freight demand. Its unlike anything we've seen before. Rapid deterioration in national freight demand. Spring is usually one of the best times.



Finally, one of my concerns is that businesses have been ordering more than they need because of the myriad of supply chain issues. The risk is that if demand falls then they will be stuck with too much inventory which will impact future growth.

This is a time to fasten our seatbelts because we could be embarking on a very bumpy ride that can be fast and furious at times from an interest rate perspective. Fortunately, we have some of the most solid operating fundamentals we have ever experienced. Demand for apartments is tremendous and rents are growing quite significantly. We have financed our properties to be able to absorb higher rates and still stay on the playing field to capture the benefits we

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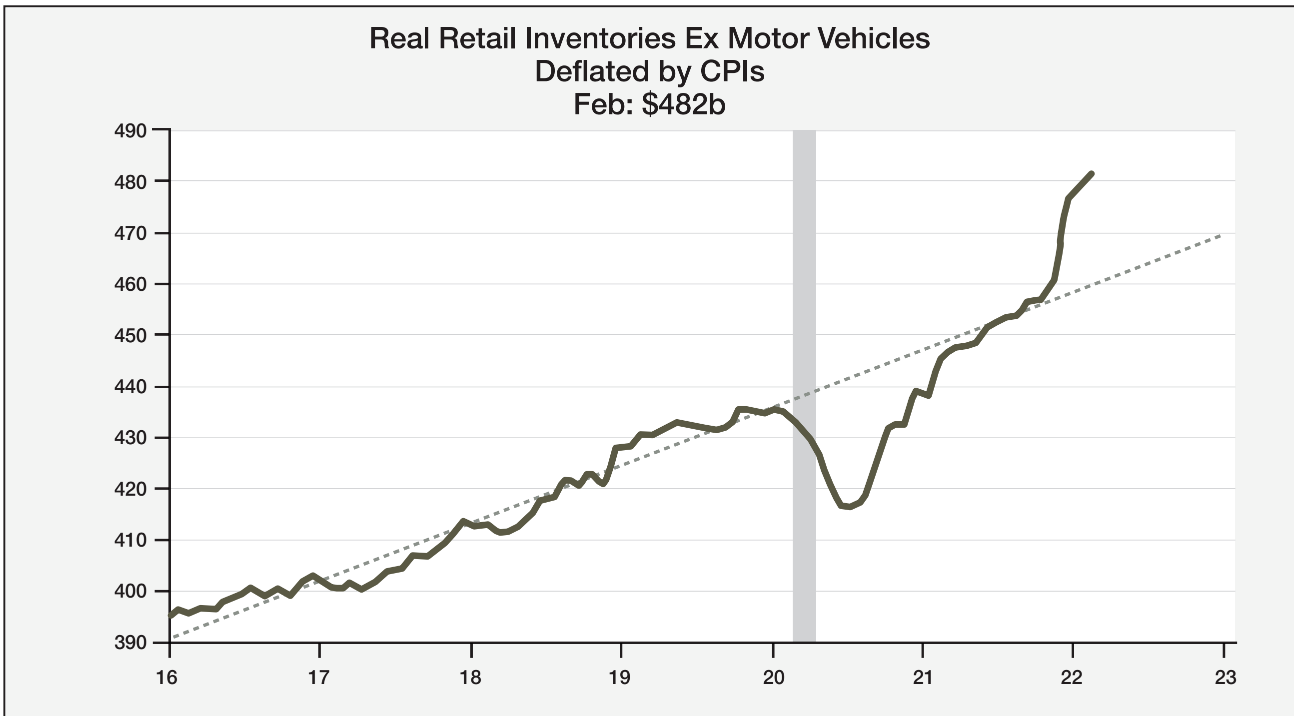

see on the horizon for apartment performance. Some of our more leveraged competitors may not be so fortunate if they do not have the financial staying power to support their assets as their cost of funds goes up significantly due to their high leverage and high spread loans. Fortunately, we believe we are stressed for success.

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