

QUARTERLY UPDATE

CWS CAPITAL PARTNERS LLC

CWS Capital Partners LLC

CWS

CALENDAR OF EVENTS

Monday, September 1, 2014

Labor Day
CWS Offices Closed

Wednesday, October 15, 2014

3rd Quarter 2014 Estimated Tax Payment Due

Friday, October 31, 2014

3rd Quarter 2014 Quarterly Packages Mailed

November 2014

CWS Capital Partners
Semi-Annual Conference Call

Thursday, November 27, 2014

Thanksgiving Day
CWS Offices Closed

Friday, November 28, 2014

Day after Thanksgiving
CWS Offices Closed

Wednesday, December 24, 2014

Christmas Eve
CWS Offices Closed

Thursday, December 25, 2014

Christmas Day
CWS Offices Closed



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THE CWS CIRCLE OF LIFE

By Gary Carmell



The focus of this article is to illuminate two important ways CWS generates long-term returns for our investors. The

first way is providing investors with tax-deferred wealth preservation. The second way is making investments in which we believe the competition for particular investments is subdued and, as a result, we can find compelling values. A warning up front: this article is not for the quantitative faint of heart. A lot of numbers will be presented and some of the narrative will be somewhat complex in order to convey important conclusions from the data presented.

Let's start with tax-deferred wealth preservation. By deferring taxes an investor can have more of his or her wealth preserved because more capital can be invested for longer periods of time. Real estate provides a very powerful wealth preservation tool in the form of tax-deferred 1031 exchanges. While stock market investors

Continued on Page 2

have to pay tax upon gains generated with every sale, this is not the case for real estate investors who carry out 1031 exchanges. Since tax-deferred exchanges became available in the mid-1980s, CWS has purchased over \$900 million in properties via 1031 exchange transactions. These exchanges have deferred many millions of dollars of taxes for our investors over the years.

Given CWS' extensive history with 1031 exchanges, we have a very interesting database of transactions to draw from and track how investments made a long time ago have performed for investors who elected to reinvest all of their sale proceeds into new property investments via 1031 exchanges. From time to time we go back and look at how investments made a long time ago have performed over many years after being exchanged into other properties. Recently we looked at someone who invested \$45,000 in two manufactured home communities that were purchased concurrently in 1985. Fast forward to 2014 and the capital has been reinvested into four apartment communities, three of which remain active today. The results are very interesting and I believe compelling in terms of showing the benefits of long-term real estate investing. The ride is not always smooth, but in the long run the results are quite satisfactory.

	1985	1985-April 2014	Multiple of Investment
Original Investment	\$45,000		
Cash Distributed (through April 2014)		\$131,164	2.91
Estimated Value of Three Properties Now Invested in		\$229,233	5.09
Totals	\$45,000	\$360,397	8.00

One can see the tremendous benefits of investing one's capital in income producing properties and being able to reinvest the sale proceeds on a tax-deferred basis into new real estate investments. The two original investments are now invested in three apartment communities and have already returned a multiple of 2.91 times the original investment via previous cash distributions, much of which was sheltered from immediate taxation. In addition, the estimated value of the three investments is now approximately five times the original investment made back in 1985. This analysis does not take into account what would have happened had the distributions been reinvested. Obviously the results would be even better if this had been included as well.

I point this out to illustrate the importance of long-term investing. This investor would have far

less money working for him had he not exchanged each time the opportunity was presented and the dividends would have been less as well because fewer dollars would have been working for the investor. One can see that a meaningful portion of the return has come from dividends, but even more value is derived from the appreciation of the investments based on the estimated values. Thus, it is important that we do our best to invest in assets that can provide a very compelling total return (cash flow plus appreciation) for the risk borne. Certain situations may result in more cash flow early on, while in other situations it may be less if we think we are buying a property at a discount that more than compensates us for the lower cash flow relative to alternative opportunities. When would such cases arise? The two most common involve loan assumptions and turnaround properties. The rest of the article focuses on loan assumptions because the second strategy of turnaround properties doesn't require much explanation as to why it can be lucrative. Loan assumptions are far more complex, and require a more thorough explanation as to why we often times find them to be rewarding investments.

Buying Properties with Unattractive Debt

Beauty is truly in the eye of the beholder when it comes to this strategy. With interest rates at very low levels, most property purchasers want to lock in today's favorable rates for longer periods of time. This results in properties that can be purchased using new, market-rate debt to trade at higher values than those requiring the assumption of older, higher cost debt, holding everything else constant. Historically, we try to avoid situations where the buying pool is pretty large because it's usually too crowded and competitive for us to find compelling values. When it comes to buying properties with fixed-rate loans that have large pre-payment penalties, however, the buying pool shrinks considerably for the following reasons:

- Leverage may be too low - buyers have to invest too much equity relative to the purchase price which is either too much money to raise and/or hurts the overall projected returns.
- Starting cash flow is too low for buyers that have minimum cash returns promised to their investors.
- Loan assumptions often result in buyers needing to make changes to loan documents that may not always be approved by the lender and thus may make it harder to sell the property because of the time and complexity involved.

- Buyers may not be comfortable with the interest rate risk if the loans being assumed have maturities of three years or less due to the risk of refinancing in an environment when rates may be higher, loan terms more stringent, and the property has not been seasoned long enough to have grown its operating income sufficiently to overcome these loan underwriting headwinds.
- Sub-optimal loan conditions that can't be changed in the loan documents tend to lessen the buyer pool. Some loan terms are "take it or leave it" which may repel a number of buyers who are not willing to live with them.
- A loan assumption can take a long time, requires patience, and sophistication to work through the details of trying to conform previously negotiated loan documents to ones that buyers would have negotiated themselves had they been putting new financing in place.

These are a lot of barriers to overcome for many prospective buyers. Many of them decide to avoid the headaches that come with slogging through the issues cited above. For CWS, we look at this as a potential opportunity provided that we receive a deep enough discount to compensate for all of the issues outlined above. Interestingly, we have found that one of the benefits of loan assumptions is that the length of time to complete the assumption can actually be quite beneficial when purchasing a property in a strong market with improving fundamentals. We are able to put the property under contract at a fixed price and during the escrow period, which can sometimes be as long as six months, the fundamentals improve such that by the time escrow closes, property performance may be ahead of projections. This is something we recently experienced with Marquis at Legacy in Plano, Texas. We put the property under contract in late 2013 and during a lengthy five month escrow period Toyota announced that it was moving approximately 3,000 jobs from California to a new location very close to our property. This made closing on this transaction far more compelling because our purchase price was favorable before the Toyota announcement and became much more so after.

We "run the numbers" for each acquisition carefully to determine if our discount is sufficient enough to offset an all cash buyer not assuming a loan utilizing cheaper debt, often times with more leverage. The analysis is a bit tricky, however. Usually with loan assumptions, one has

to make a larger down payment, which can diminish the returns since there is a greater cash requirement. On the other hand, the risk should be lower because less money is borrowed and the total profit might be larger, as well, since the purchase price is lower. Said differently, doubling an investment of \$10 million produces more dollar profit than doubling an \$8 million investment.

Let's try to quantify some of what I've been discussing by using a hypothetical example. If a seller is trying to dispose of a property with a fixed-rate loan with a balance of \$25 million at a rate of 4.50% and a remaining term of five years, then the pre-payment penalty would be approximately 15% of the loan amount, or \$3.75 million. This is often too high of a penalty for a seller to pay and he tries to mitigate this by requiring a buyer to assume the loan so that the loan is not pre-paid and remains in place. This suspends triggering a pre-payment penalty. The formula to calculate the pre-payment penalty is highly punitive to the borrower because it assumes that the lender can only reinvest the proceeds in risk-free Treasury securities for the remaining term of the loan. This results in a steep cost because it does not take into consideration the potential for the lender to reinvest the proceeds in riskier, but higher-yielding investments.

As a buyer, however, we can't borrow as cheaply as the U.S. Treasury so our cost of funds is a lot higher. For example, the five-year Treasury yield is approximately 1.65%, but if we wanted to borrow to purchase an apartment community for five years it would cost us about 3.65% or so, or approximately 2% more. This translates into an opportunity cost (resulting from paying a higher than market interest rate) of about 7% of the loan amount, or \$1.75 million, quite a bit less than the pre-payment penalty. Thus, the challenge for us is to capture some of the difference between the \$3.75 million and \$1.75 million in purchase price savings. Clearly it makes sense for the seller to require a buyer to assume the loan unless he thinks that he can get a price high enough to compensate him for paying the pre-payment penalty.

We have recently closed on two acquisitions using this strategy. The first was a property in Atlanta, Georgia called Marquis Midtown District which involved a loan assumption with approximately seven years remaining while the second was the aforementioned property in Plano, Texas, The Marquis at Legacy. This loan had approximately three years remaining, thereby allowing for a refinance event more quickly. We did an analysis comparing some of the key metrics of the two investments based on the prices we paid and our estimate of what these properties would have traded for had they not involved loan assumptions.

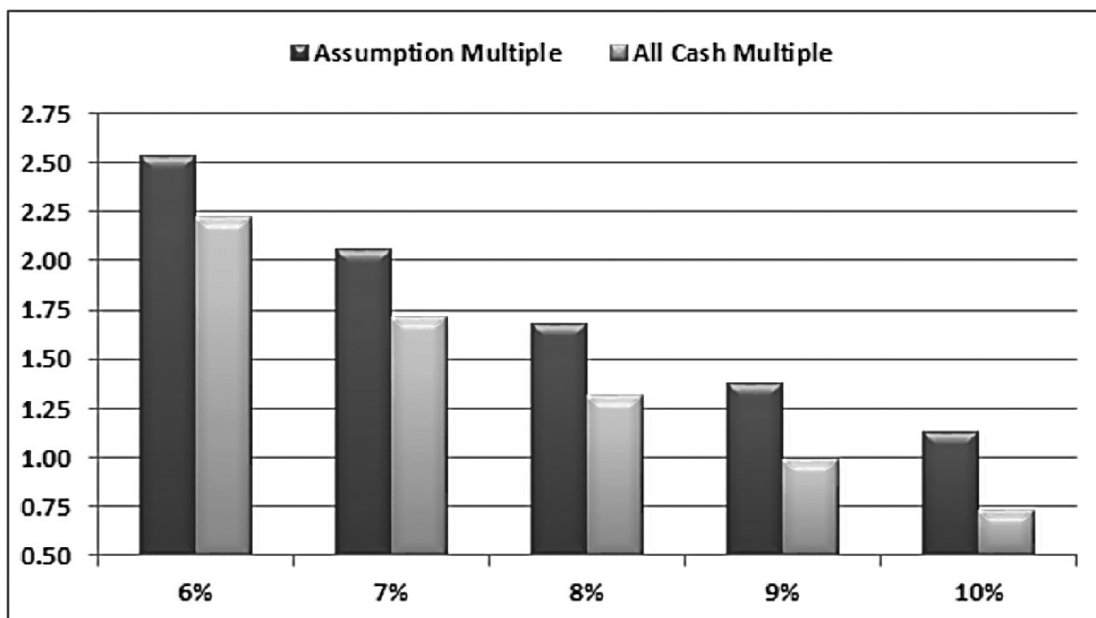
The following table shows our comparison for Marquis Midtown District.

	<u>Loan Assumption</u>	<u>All Cash</u>
Purchase Price	\$ 52,000,000	\$ 57,660,000
Purchase Price Per Unit	\$ 139,785	\$ 155,000
Equity	\$ 17,300,000	\$ 16,247,168
Loan	\$ 36,400,000	\$ 43,245,000
Total Capitalization	\$ 53,700,000	\$ 59,492,168
Unlevered Yield	5.61%	4.91%
LTV	67.80%	75.00%
Interest Rate	4.72%	4.00%
Debt Maturity	11/1/2020	7-year term
Average Current Cash	6.44%	7.10%
Cash + Amortization	10.28%	10.03%
Exit Price	\$ 71,004,069	\$ 71,004,069
Gross IRR	18.57%	16.42%
Multiple	2.53	2.22

Had we purchased the property all cash and utilized the approximately 68% loan to purchase price we used for the loan assumption, then we would have had to invest approximately \$4 million more in equity as compared to an all cash buyer. This would have generated sub-optimal returns. Instead, we were able to offset much of this by purchasing the property for an estimated \$5.7 million less than the all cash buyer, thus only raising the equity requirement by \$1.1 million. This is the key to generating a higher projected overall return while offering less risk in terms of having approximately \$6.8 million less debt encumbering the property. Although the average distributions are slightly lower, the higher amount of amortization results in more equity build up and a higher overall return because of the price that was close to 10% lower than buying it all cash. In addition, the lower price and loan amount create somewhat of a buffer in the event that interest rates increase and/or the multiple paid by buyers for properties drops in the future. Only by looking at all of the key metrics in totality can one discern that there is much more than meets the eye to this investment than starting cash flow. Yes, recurring cash flow is a very important component of the overall return, but there are times where we are sufficiently compensated and exposing ourselves to less risk by sacrificing some in the early years in exchange for greater overall benefits during the life of the investment.

The following graph shows how the investment multiple varies by terminal capitalization rate between the loan assumption and all cash scenarios. The terminal cap rate on the x-axis represents the yield required by a purchaser to invest in the asset assuming no debt is used. Today, capitalization rates are typically between 4.75% to 5.50% depending on the age, quality, location, interest rates, lending market, etc. This analysis assumes that required yields will be higher in the future.

One can see that in every scenario the multiples on one's investment (prior to any profit sharing with the General Partner) are higher for the loan assumption with the spread getting wider as yield requirements increase. This strategy results in a fairly meaningful margin of safety to help protect ourselves in the event the multiple paid for apartment communities drops in the future.

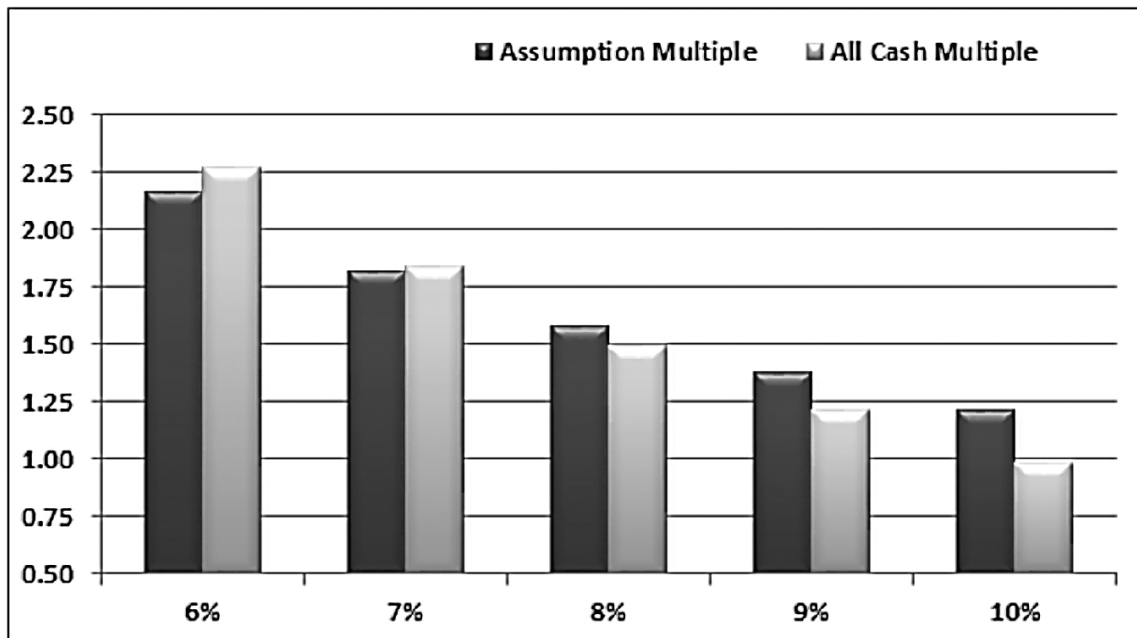


Here is the second example with Marquis at Legacy. In this case, the starting loan as a percentage of the value is much lower as compared to the all cash purchase. We were comfortable with this, however, given the relatively short maturity (approximately three years) where we believe there is a strong potential to borrow some of this "excess" down payment back because the price we paid for the property, the improvements we're making to it, and the tremendous demand fundamentals from Toyota and other job announcements, should result in meaningful value improvement during the next three years.

This is the best of both worlds in terms of capturing the key strategies laid out in this article. Not only are we able to buy an extraordinarily well-located asset at a very good price because of the loan assumption, but we're also exchanging money into it via the sale and reinvestment of The Marquis at Willow Lake proceeds, thereby deferring taxes and having more capital working for the investors who choose to participate in the 1031 exchange.

The following is the table and graph for Marquis at Legacy like was used for Marquis Midtown District:

	Loan Assumption	All Cash
Purchase Price	\$ 23,900,000	\$ 26,200,000
Purchase Price Per Unit	\$ 89,179	\$ 97,761
Equity	\$ 11,078,544	\$ 9,102,084
Loan	\$ 15,485,275	\$ 19,650,000
Total Capitalization	\$ 26,563,819	\$ 28,752,084
Unlevered Yield on Purchase Price	6.01%	5.30%
LTV	58.3%	75.00%
Interest Rate	4.01%	4.00%
Debt Maturity	10/1/2017	7-year term
Average Current Cash	7.05%	5.98%
Cash + Amortization	9.90%	8.36%
Exit Price	\$ 34,572,028	\$ 34,572,028
Gross IRR	16.52%	14.29%
Multiple	2.16	2.27



Our refinance assumptions are more conservative than what is currently available in the market today in terms of loan to value and interest rate. As a result, the multiple is slightly lower in the 6% capitalization rate scenario in the graph above. If we were to use loan terms similar to what's available today in terms of loan-to-value, then the multiple for the loan assumption scenario would be higher across the board like it is in the first example.

Sometimes people ask us what the secret to our long-term success has been and we often say it's been by doing what's smart and not getting locked into a dogmatic investment approach. As Charlie Munger has famously said, "To the man with a hammer, every problem looks like a nail." We have made it a point to have many tools in our toolbox to be able to add value in a multitude of ways. We like to zig when others are zagging and we can do this by having the following capabilities:

- Acquiring properties
 - With new market rate debt
 - Utilizing variable rate loans when others will only use fixed
 - Assuming loans
- Repositioning assets
 - Light upgrades
 - Significant upgrades and property enhancements
- Buying and managing urban properties
- Buying and managing suburban properties
- Owning and operating student housing properties
- Developing high-quality market rate apartments
- Developing student housing properties

We have carefully built an organization that can identify opportunities, put properties under contract, do the due diligence, arrange the financing and capitalizing on CWS' reputation of being one of the premier borrowers of Fannie Mae and Freddie Mac, raise the money from investors, integrate new acquisitions into our operating system, manage the properties, report on the investments, distribute to our investors and track their ownership, refinance properties, sell properties at the opportune time, and reinvest the proceeds on a tax-deferred basis via 1031 exchanges. I think of this as "The CWS Circle of Life" and we look forward to it continuing to go round and round for many years to come resulting in continued success for our investors.